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**Transformation of China's State
Commercial Sector Governance:
A Case Study of China's Largest Insurance
Company, China Life**

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Thesis Submitted for the Degree of Doctor of Philosophy

Durham University Business School

University of Durham

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Abstract

This thesis seeks to detail and advance path-based explanations for the changing character and conduct of Chinese state sector governance at both evolving national and current leading firm level. The ruling Chinese party-state has expressed concern about how governance failings lower operational efficiency in the state sector over three decades while continuing to devise and implement different reforms in the process. However, empirical research often suggests that its gradualist or incremental approach to reform can also result in a mosaic of different transplanted governance institutions which are not necessarily fully or immediately compatible with China's own unique context.

This thesis specifically examines the transformative dynamics of China's state sector governance system through the prism of path based theory in order to provide a more holistic and in-depth understanding of how that context and leading Chinese actors' own conduct both exert salient influences over governance practices. It uses a mixed-method strategy at both national and firm levels to derive a deeper and more holistic understanding than any one single method alone might do. Overall it finds governance reform to be characterized by a relatively *unsynchronised* and *challengeable* process of policy making and implementation which allows for some degree of flexibility and openness. Its more detailed findings also question path dependency type explanations' emphasis upon continued institutional stability and reproduction. These findings further suggest that the actual reform is not necessarily the collective and consensual quest for ever high levels of efficiency which certain financial economists typically assume. It can also depend upon the outcome of other competing pressures between increased marketization and competition on one hand, and different demands for maintaining extant governance structures and vested interests on the other. The former are no less legitimate and, in principle, urgent concerns for both policy makers and other leading stakeholders than the latter. Embedded characteristics cannot just be reduced to efficiency-technocratic considerations for inducing different competitive performance when these neglect how redistributive an economic governance system can be, and also the essentially mediated efficacy of certain transplanted mechanisms. Much of the convergence-divergence debate regarding national economic governance systems has nevertheless been conceived in efficiency and competition terms alone. However, this thesis suggests that the promulgation and transplantation of SSG reform policies needs to take the specific country context into greater consideration if it is to be both more meaningful and effective.

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Table of Contents

Abstract	i
Copyright Declaration	ii
Acknowledgements	iii
Table of Contents	v
List of Abbreviations	ix

Chapter 1 Introduction

1.1 Research Motivation and Questions	1
1.2 Research Background	3
1.3 Research Design and Structure	6

Chapter 2 Understanding Chinese State Sector Governance

2.1 Introduction	9
2.2 Conceptualising SSG	9
2.2.1 Defining Governance	10
2.2.1.1 Governance as Corporate Governance.....	10
2.2.1.2 Governance as New Public Management	10
2.2.1.3 Governance as Network Coordination.....	11
2.2.1.4 Governance as ‘Good Governance’	11
2.2.1.5 Governance as Global Governance.....	12
2.2.2 Governance of State Sector.....	13
2.2.3 Good Governance in State Sector	17
2.3 Cross-National Variation in SSG	20
2.3.1 Privatisation and Market-Based Governance.....	21
2.3.2 Alternatives to Privatisation and State-Centric Governance	23
2.4 Reviewing Relevant Theories	26
2.4.1 Neoclassical Theories	27
2.4.1.1 Market Equilibrium.....	28
2.4.1.2 Rational Choice	30
2.4.1.3 Property and Ownership Rights	32
2.4.2 Political-Economic Perspectives.....	34
2.4.2.1 State Developmentalism	35
2.4.2.2 State Entrepreneurialism	38

2.4.2.3 Political Economy of Gradualism	40
2.4.3 A Political-Economic Perspective on Chinese SSG: Static versus Dynamic	42
2.5 Summary.....	46

Chapter 3 A Path-Generation Perspective on Chinese State Sector Governance

3.1 Introduction.....	48
3.2 A Path-Based Approach	48
3.3 Institutional Continuity in SSG.....	52
3.3.1 A Path Dependence Perspective	52
3.3.2 Explaining Self-Reinforcing Institutional Stability	54
3.3.2.1 Utilitarian Factors	55
3.3.2.2 Functional Factors.....	56
3.3.2.3 Power and Legitimation.....	57
3.3.3 The Limits of Institutional Continuity	59
3.4 Path Generation	61
3.4.1 Sources of Path Generation.....	61
3.4.1.1 Functional Pressure	61
3.4.1.2 Political Pressure.....	62
3.4.1.3 Structural Factors: Embeddedness	63
3.4.1.4 Structural Factors: Openness	63
3.4.2 Path-Generation Dynamics	64
3.4.2.1 Displacement.....	65
3.4.2.2 Conversion	66
3.4.2.3 Layering	67
3.4.2.4 Drift.....	68
3.4.3 Role of Social Actors	69
3.5 Path Generation, Chinese SSG Reform and Propositions	71
3.6 Summary.....	76

Chapter 4 Research Design and Methodology

4.1 Introduction	78
4.2 Strategy of Inquiry: A Quantitatively Embedded Case Study	79
4.2.1 Research Objectives and Implications for Research Design	79
4.2.2 A Mixed-Methods Approach	80

4.3 Research Design: A Quantitatively Embedded Case Study	82
4.3.1 Research Procedures	83
4.3.2 Primary Qualitative Analysis	85
4.3.3 A Single-Case Study	86
4.3.4 Embedded Quantitative Analysis: Event Studies	91
4.3.4.1 Research Context	91
4.3.4.2 Sample Size and Variable Definition	93
4.3.4.3 Regression Procedure	97
4.4 Qualitative Data Collection in the Single Case Study	101
4.4.1 Elite Interviews	101
4.4.2 Archival Data	103
4.5 Qualitative Data Analysis and Generalization	104
4.5.1 Analysing Individual Interview Transcripts	105
4.5.2 Generalizing Individual Experiences	107
4.5.3 Follow-up Interviews	108
4.6 Validating Procedures	109
4.7 Summary	113

Chapter 5 Path-Based Explanations for Corporate Governance Reform in China's State Controlled Corporations

5.1 Introduction	115
5.2 An Actor-Based Analytical Framework	115
5.3 Central Government and SOEs	117
5.4 Ministries, Local Governments and SOEs	130
5.5 Managers and SOEs	139
5.6 Public Investors and SOEs	146
5.7 Overseas listing and International Expansion	151
5.8 Summary	161

Chapter 6 State Sector Governance Reform at Individual Firm Level: The Case of China Life

6.1 Introduction	163
6.2 Historical Development of China Life	163
6.3 Governance System of China Life Prior to Overseas Listing (1949-2000)	165

6.3.1 Governance System	166
6.3.2 Managerial Tasks and Incentives	170
6.3.3 Regulatory Reform and Administrative Streamlining	174
6.4 Restructuring, Board Institutions and Overseas Listing (2000-2004)	176
6.4.1 Capital Shortage and Corporate Restructuring	177
6.4.2 Board Institutions and Insider Control.....	181
6.4.3 Overseas Listing, Transparency and Further Reform Drive	189
6.5 Power Tension, Party Control and Internal Audit (2004 up to now)	195
6.5.1 Rising Corporate Power	195
6.5.2 Renewed Political Control and Managerial Oversight	198
6.5.3 Internal Audit and Risk Control.....	207
6.5.4 Assessment by International Investors and Implication	214
6.6 Summary.....	220
 Chapter7 Discussion: Path-Generation Explanations on China's State Sector Governance	
7.1 Introduction.....	222
7.2 Dynamics of China's Corporate Governance Reform	222
7.3 Research Findings and Propositions	230
7.4 Methodological Implications of a Path-Based Approach.....	236
 Chapter 8 Conclusion	
8.1 Elements of Corporate Governance Reform.....	239
8.2 Dynamics and Outcomes of China's Corporate Governance Reform	241
8.3 Future Research Agenda and Concluding Remarks	244
 Appendices STATA Syntax and Results	
Appendix 1: Syntax and Result for CAR Calculation and Regression.....	247
Appendix 2: Syntax and Result for Cross-Sectional Regression in Chapter 5	256
Appendix 3: Syntax and Result for Cross-Sectional Regression in Chapter 6	260
Bibliography	264

List of Abbreviations

American Depositary Receipt	ADR
Association of South East Asian Nations	ASEAN
Audit Committee Independence	ACI
Board of Directors	BOD
Board Independence	BI
Central Government Control	CGC
CEO/Chairman Duality	CD
Cross-Border Mergers and Acquisitions	CM&As
China Insurance Regulatory Commission	CIRC
China National Petroleum Corporation	CNPC
China Securities Regulatory Commission	CSRC
Cumulative Abnormal Return	CAR
Debt-Equity Ratio	DER
Firm Age	FA
Firm Size	FS
Group Affiliation	GA
Guangdong International Trust and Investment Corporation	GITIC
Hong Kong Dollar	HK\$
Hong Kong Stock Exchange	HKSE
Hong Kong Securities and Futures Commission	HKSF
Initial Public Offering	IPO
International Business	IB
Local Government Control	LGC
National Audit Office	NAO
New Public Management	NPM
New York Stock Exchange	NYSE
Newly Industrialised Countries	NICs
Non-Governmental Organizations	NGOs
Non-Performing Loan	NPL
Ministry of Finance	MOF
Multinational Enterprises	MNEs
Operation Profit Margin	OPM

Organisation for Economic Co-operation and Development	OECD
Outward Foreign Direct Investment	OFDI
Ownership of Largest Shareholder	LS
Return on Assets	ROA
State-Control Corporation	SCC
State-Owned Enterprise	SOE
State-Run Unit	SRU
Supervisors Board	SB
Target Status	TS
The Chinese Communist Party	CCP
The Institute of Internal Audit	IIA
The State Asset Supervision and Administration Commission	SASAC
The State Economic Commission	SEC
The State Planning Commission	SPC
The US Securities and Exchange Commission	USSEC
Tobin's Q	TQ
U.S. Dollar	US\$
World Trade Organisation	WTO

Chapter 1

Introduction

1.1 Research Motivation and Questions

China is changing the global economy (Schuman, 2012) for, despite financial turmoil, the economy continues to grow, albeit at a slower rate, so that its international importance becomes ever more apparent (Tricker, 2012). With this rising economic influence, its state-owned enterprises (SOEs) have lately rapidly and consistently upgraded their presence outside China itself. With a record number in the latest Fortune 500 List (73 by late 2012), SOEs (and their directly-controlled entities) accounted for over 40 per cent of China's non-agricultural GDP, according to the U.S.-China Economic and Security Review Commission. By the end of 2011, the total assets of China's 121 central SOEs managed by the State Asset Supervisory and Administration Commission (SASAC) reportedly amounted to US\$ 2.9 trillion, up from US\$ 360 billion in 2002 (Galvez, 2012).¹ China officially intends to reduce their total number and focus upon fewer, globally competitive large conglomerates which might act as key players within the selected strategic sectors such as aviation, military, power generation, petroleum, finance, mineral resources, shipping and telecommunications. Their growing overseas investment and business expansion contrast even more significantly with their peers from other developed economies. Although SOEs' outside expansion – either by international listing or cross-border investments – can benefit the host countries, the side effects of their business conduct and, in particular, the quality of the state sector governance (SSG) as a whole are still in question. The exposure of accounting-related frauds and scandals among the overseas listed companies has resulted in significant financial losses and reputational damage that still afflict the party-state.

As regards SSG various different reforms have been attempted. Apparent performance deterioration over the late 1980s suggested that initial reforms had disappointed (Qian, 1999). Since the early 1990s, establishing “modern enterprise system” has been officially regarded as the core element in China's state sector reform (Tam, 1999). Continuous efforts imply progress in building market institutions, including industrial restructuring, corporatisation, introducing corporate governance (CG) mechanisms and stock market listing. However, up to now, SOEs fall short of being modern industrial corporations (Nolan and Wang, 1999; Pei,

¹ This excludes the major state owned financial institutions outside SASAC's jurisdiction.

2009; McGregor, 2012). Empirical research (e.g. Tenev et al., 2002; Ewing, 2005) underlines how different reforms have resulted in a complex mosaic of transplanted governance institutions. Assessments can nevertheless show nuanced understandings about the mediating or even constraining impact of political institutions upon ultimate policy outcomes (see Tam, 1999; Ewing, 2005; Wu, 2005; O'Connor et al., 2006). Leading commentators here associate governance malpractices such as bureaucratic intervention, asset tunnelling and insider trading with certain particular forms of ownership control by shareholding agencies. While the efficacy of SSG mechanisms may ultimately rest upon more credible market competition and stronger regulatory capacities, complementary socio-economic institutions are still underdeveloped in China (Tenev et al., 2002; Cheng and Lawton, 2005; Pei, 2009; Ahrens et al., 2011). Chinese SOEs not only face similar problems to others elsewhere, but also political problems inherited from past central planning (Cheng and Lawton, 2005). For financial economists, sustainable improvements in SSG are highly unlikely without fundamental changes in ownership patterns and political institutions (Pei, 2009).

On the other hand, the overall success of China's economic reform questions whether socialist political institutions are always or even necessarily rigid and hostile to policy innovations. Reforms have here been conducted through the same political institutions and bureaucratic authorities which have often existed since the 1950s. Nevertheless, even without structurally changed political institutions, policymakers have moved towards a competitive "socialist market economy with Chinese characteristics".² For Shirk (1993, pp. 14-15), contests for leadership succession – as occurred during 1978 and 1980 between Deng Xiaoping and Hua Guofeng and also during 1996 and 1998 between Li Peng and Zhu Rongji – led contending factions to propose more innovative solutions for persistent economic problems (Jung, 2011; Oi, 2011). These included particular programs to procure above-quota agricultural output at market prices, to expand enterprise autonomy, to allow enterprise management to share the profits, and to spin-off the non-performing asset for stock market listing, have changed the economic and career incentives of bureaucracies and managers by giving them greater interest in promoting different reform initiatives. Despite the lack of political reform, marketization gained momentum, and mass living standards

² Studies of Chinese centrally planned economy often propose many commonalities with the former Soviet Union experience of socialist planning (Jefferson and Rawski, 1996). Such an oversimplified perspective neglects the fact that governance apparatus in China's state sector has been far more comprehensive and complex than in other socialism economies.

improved. Over successive decades, bureaucracies, managers and employees have more vested interest in reform, while for Shirk (1993, p. 5), “no one suggested turning back to the command economy”. For Dickson (2003, p. 37), the Chinese Communist Party’s (CCP) adoption of new recruitment and evaluation criteria reflected a switch of focus from class struggle to economic modernization, especially when compared with other former socialist regimes. As regards SSG reform, it is therefore reasonable to ask:

- Given the constraints faced, is the Chinese SSG system significantly deviated from past central planning?
- Who first initiated and then continued its reform? Which other actors were involved?
- What are the influences of specified socio-political constraints? What different policy outcomes are claimed and/or observed to result?
- What are the process and dynamics of reform in action? What strategies have been employed by the leading actors to overcome the constraints encountered?

1.2 Research Background

In seeking to answer these questions this thesis details and explains the particular dynamics behind the sector’s governance system. Drawing upon the path-generation literature, it rejects as over-static that point of view which stresses the constraining effects of current institutional arrangements, and instead pays more attention to how transformation occurs, and which actors help make SSG reform actually happen. The thesis starts from the view that it is possible to study related policy-making and implementation in a socialist regime as one would also do in advanced capitalist countries by similarly examining the pattern of interaction among different stakeholders and wider socio-economic environments. The Variety of Capitalism (VoC) approach to institutional transformations in these democracies has often examined the way in which different sets of institutional arrangements generate distinctive political and economic incentives which then lead towards particular policy outcomes. It underlines the importance of institutional embeddedness and leading social actors’ interactions for understanding cross-national variations in policy and practice. For example, Vogel (2006) analysed the reform initiatives and processes which the Japanese government and leading industrial sectors have undertaken since the 1990s, ranging from labour relations to the financial system and corporate governance. This study found that, while existing institutions have left heavy imprints upon particular reform measures, and

also limited Japan's convergence with liberal market orthodoxy, both prolonged economic problems and globalization eventually propelled its leading actors to go beyond continued routine adjustment. Its concept of “patterned innovation” illuminated how industries and government can actively devise innovative solutions without being entirely constrained by other considerations (Chen, 2008).

As regards China economic reform questions the actual and potential adaptability of the CCP (Dickson, 2000). Here Dickson’s argument was supported by Nathan’s (2003, pp. 6-17) description of the combination of Party and state as “authoritarian resilience”, implying that the CCP has developed self-improving solutions which enhance its own political survival. Fan’s (2012) review likewise suggests that, although the state has steered SOE reform, the necessity for its continuation has also turned the state itself into another object for reform. While Fan does not discount the political feasibility of governmental reform, other political scholars have identified further potential political transformation. Thus Nolan (2005) recognized that China was in search of its own “third way” while still being in the midst of economic development and industrialization, this “third way” being a creative symbiotic interrelationship between state and market. In this regard, the interplay of politics and economics emphasized above constitutes a more dynamic approach to understanding how both governance practices change and different developmental paths evolve.³ While such arguments may exclude the possibility of institutional lock-in, this thesis will employ a distinct path-generation perspective to fully grasp and assess China’s state sector reform.

Neoclassical economists and transnational bodies tend to play down or ignore the particular socio-political settings where a state sector operates. It has been frequently assume that institutional rules of different line authorities are not really relevant and that any governance failure will be addressed sooner or later due to competitive pressure from market liberalization. Unsurprisingly the prevailing guidelines for SSG reform are drawn heavily upon the ‘free market’ principles and the much advocated Anglo-American model of CG featured by disperse ownership structure and separation of ownership and control (OECD,

³ Early scholars, most notably Robert Bates (1983), Susan Shirk (1993) and Barry Naughton (1996), used similar institutional analysis to understand policy-making and implementation process in China and other non-democratic, authoritarian, less developed countries. Similar approach has been applied to analyse the reform dynamics of China’s state sector governance.

2005a, 2005b, and 2011a).⁴ However, to the extent that the complementary institutions have yet developed in transitional economies, the piecemeal and pragmatic imposition of CG codes and regulations often achieve limited effect. This in turn questions the value of remedial prescriptions drawn from Anglo-American sources alone (Todd, 2010; Bebchuk and Weisbach, 2010; Ahrens et al., 2011). Saich (2011) maintains that effective SSG involves strengthening or developing institutions, enacting regulations, building administrative and monitoring capacity, and political support. Although this thesis does not deny the possibility of such competitive pressure arising from market liberalization, it places Chinese economic reform in a broader institutional context in order to make actual reform dynamics more explicit. It recognizes how China is particularly distinctive in terms of:

- In contrast to the transitional economies in Eastern Europe, social and economic transition has here been more gradual and deliberately paced, given the lack of complementary socio-economic conditions. As one official assessment put it, “markets in capital, land technology, and labour” are still underdeveloped; the government has only “incomplete capabilities in macroeconomic management” and achieved limited success in “forming a system of public finance... and improving fundamentally the management or/and governance systems of the state owned enterprises” (O’Brien, 2008; see also Pei, 2009).
- The authority relationship between CCP and government is at the core of reform decision making. The CCP considers itself as “the organized expression of the will of the society” and “the leader of government work” (see Schurmann, 1968, p. 110). This has two implications. First, while the communist party is not directly accountable to citizens, its legitimacy concerns are often drivers for reform. Second, while the CCP retains absolute authority over the bureaucratic apparatus, it delegates much of the actual administration involved. Within this delegated relationship, the CCP can be conceived as the “principal” while the government is the “agents” (Shirk, 1993, p. 55).
- For an authoritarian regime like China, the state sector is of vital importance for the party state, for it not only contains the strategic industries of “commanding height” but also constitutes “the centrepiece of a vast patronage system” to secure its legitimacy and

⁴ As noted in the next chapter, all these rely on various prerequisites for its successful operation including perfect market competition, developed financial market, rule of law, and a regulatory regime of high accountability and transparency.

continuing loyalty from its key constituencies. Accordingly, the party-state is reluctant to relinquish its control and, more importantly, the ability to protect and even improve the rents obtained under gradualist reform, especially where these help the ruling party co-opt emerging social elites and other groups which could potentially threaten its authority.

- Despite certain structural similarities, the key political and economic authorities in China have been less monolithic and more fragmented than those of the former Soviet Union. The departmentalism and federalism so characteristic of the Chinese political system suggests that policy-making over the post-Mao era is less determined by the moral-ideological vision of charismatic leaders and more consensus-based. For Huntington and Fukuyama (2006), the combination of divided authorities and consensus decision-making can result in compromised solutions and slow reform. This questions the orthodox finance-economic literature presumption of monolithic and top-down policy-making in the socialist state.

1.3 Research Design and Structure

The dynamic nature of institutional change also poses difficult methodological issues. Indeed, Hurmerinta-Peltomäki and Nummela (2006, p. 440) argued that “if a narrow methodological approach were to be applied in this complex context, only a small slice of the reality would be revealed”. Moreover, SSG in transitional economies is a relatively new field of research for which the necessary theoretical roadmaps may not yet have fully emerged. This provides researchers from different disciplines the opportunity to invent and apply the more innovative methods required to answer questions of now growing importance. Given the special research context and the qualitatively-driven logic sought here, an “embedded design” has been chosen as the primary methodological framework, with further statistical evidence and analysis subsequently ‘nested’ within individual qualitative case research. There is a range of well-rehearsed evaluative studies about the merits of a mixed-method strategy, often emphasizing its relative merits for validating data and triangulation, in gaining a fuller picture of the phenomenon under investigation (Mason, 2006). While the overall research design adopted here can be conceived as qualitatively based, the quantitative data and analysis nested into this qualitative analysis can further elaborate upon it (Srnrka and Koeszegi, 2007). Such an elaboration model is considered to be an efficient form of deriving deeper insights and gaining greater confidence.

With their special focus upon decision-making and leading social actors' interactions, the further empirical inquiries here are primarily based on elite interviews with senior government officials, and corporate executives from China Life in particular. Valuable research data was obtained through intensive interviewing from July 2009 to September 2011 mainly in Beijing, Liaoning and Guangdong Provinces. It was so challenging to persuade these senior officials and executives to talk frankly about the issues and problems surrounding different reform initiatives that relatively unstructured interviews were essential for this purpose. To gain in-depth insight into the implementation of reforms at enterprise level, the range of interviewees was duly expanded to include other managers and employees at China Life's various regional business branches. The verification and analysis of such first-hand data were further supplemented by extensive documentary research, especially official documents and articles from Chinese economic newspapers and journals. As most topics under discussion were politically sensitive it was important to guarantee informants' anonymity and confidentiality. To provide extra protection, the empirical chapters here do not identify the informants' names and affiliated institutions, and instead use designated informant codes and dates. Specific Chinese documentary sources are cited in references.

This thesis is organized as follows. Chapter 2 identifies and uses selected theories from related economic, political and developmental literature to provide a more 'joined up' conceptualization of governance reform in China's state sector. Chapter 3 surveys selected neo-institutionalist literature on reform, with particular attention to institutional transformation among different transitional economies' chosen economic governance systems. Before specifying further research propositions, it identifies the different sources and modes of institutional transformation which 'path generation' may take into account. Chapter 4 then discusses the rationale behind the case study, given the particular context in which it is situated. It outlines the specific objectives for further research and identifies potential methodological problems. The relative merits of a mixed-methods approach are discussed in terms of its potential to mobilize multiple theories and data sources when examining particular SSG practices, thereby combining both breadth and depth of inquiry, while assuring more valid findings (Modell, 2010). It outlines data collection and analysis procedures used here for further theory building purposes.

Chapter 5 illuminates the transformative dynamics of Chinese SSG system at large drawing upon path-generation theory. It seeks to answer the questions: to what extent and how has

China's SSG actually changed? Is there either institutional continuation with incremental policy adjustments or has a more distinctive system emerged instead? What are the path-dependent or path-generating mechanisms underpinning this process? What are the leading social actors' roles? Are they simply passive receivers of given institutional constraints or else more innovative institutional entrepreneurs? The further statistical analysis then added duly elaborates upon these prior narrative accounts using simple statistical regression in order to examine how international investors themselves regard and value certain prevailing SSG practices. Chapter 6 then uses a firm-level case study of China Life to illuminate the actual dynamics of ongoing SSG reform, highlighting the proactive roles of both change agents and other specifically enabling conditions (Jing and McDermott, 2012). By taking a close look at China Life – the world's largest life insurer in terms of market capitalization – this chapter addresses the question: (1) Who are the reform actors or/and change agents? (2) How the reforms were conducted? (3) What are the results so far? The use of this leading company case presents a more dynamic, contextual and holistic analysis of actual SSG reform in action.

Chapter 7 then employs path-generation theory to finally explain SSG reform thus far. Its response to the initial research propositions incorporates the empirical evidence offered in Chapter 5 and Chapter 6 while further reflecting upon the essential methodological issues regarding (1) using a path-based approach in the Chinese context, and (2) the nature and importance of conducting in situ studies with elite actors therein. Chapter 8 finally concludes and identifies important directions for future research.

Chapter 2

Understanding Chinese State Sector Governance

2.1 Introduction

The global financial crisis, in particular the meltdown of prominent state-backed financial institutions, questioned *laissez faire* approaches to state sector governance (SSG). It also emphasized the continuing importance of linking economic with institutional factors in order to produce better explanations (Ahrens et al., 2011). The core concept of SSG is itself still emerging with important theoretical and empirical issues still to be resolved (see Hye, 2000; Bevir, 2007). This chapter seeks a more ‘joined-up’ approach which will produce better understandings of Chinese SSG reform. It will identify the impetus for such reform along with the mediating effects of surrounding Chinese socio-political factors. This requires integrating different theories and evidence to illuminate both the *diversity* and the *uniqueness* of national SSG systems while also capturing emerging real world institutional practices.

The chapter is structured as follows. The next section will define governance by examining the different contexts in which the concept has been derived and applied. On this basis, it conceptualises SSG and evaluates what constitutes “good SSG” in order to assess the implications for this and further research. Section 2.3 describes the cross-national variation in SSG systems. Section 2.4 reviews the prevailing theorems that explain the characteristics, and reform strategies of SSG. By linking political with economic perspectives, it further explains Chinese SSG, and argues that this should embrace and incorporate an explicitly political-economic perspective in order to fully illuminate and better explain its institutional embeddedness and dynamics. Section 2.5 summarises.

2.2 Conceptualising SSG

Governance has moved centre stage in much developmental discourse about developing economies (Hye, 2000; OECD, 2005a). Aside from its accepted importance, there are still important differences regarding how it should be best theorized and applied. Due conceptualization is necessary to define what is meant by *governance* and identify the institutions and loci of power whereby it is conducted among leading, in particular state

sector, actors at large. On this basis, the definition will be applied into the specific context of state sector.

2.2.1 Defining Governance

The concept of governance represents the configuration of the rules and activities of ruling (Pierre, 2000). Historically, it referred to narrowly defined phenomenon related to executive branches of the state – administrative, legislature, and judiciary – without much synergistic relation with other private sector and/or civil society actors (Hye, 2000). Its more recent formulation introduces civil society, public investors, private enterprises, and local governments as both participants and promoters of good governance, by virtue of their roles and involvement in actions hitherto kept exclusively in the public domain (Bevir, 2007). For more precise definition it is first necessary to examine the following different contexts in which the concept has been derived and applied.

2.2.1.1 Governance as Corporate Governance

This specialized use originally referred to “the system by which organizations are directed and controlled” (Cadbury Report, 1992). Corporate governance (CG) here arises from the separation of ownership and control which is an ongoing feature of Anglo-American public companies: highly dispersed shareholdings and an active stock market on one hand, and professionalizing management on the other (Berle and Means, 1932; Jensen and Meckling, 1976). While these respective parties might diverge about particular goals and risk preferences, CG encompasses mechanisms whereby shareholders might bring the interests of managers into line with their own (Eisenhardt, 1989; Walsh and Seward, 1990). Although the nature of ownership structures and interests can differ significantly outside purely Anglo-American domains, CG has become a watchword of those seeking to improve the accountability and transparency of corporate management while optimizing shareholder returns.

2.2.1.2 Governance as New Public Management

The new public management (NPM) denotes broadly those government policies and practices intended to modernise and render public sector working more efficient (Hood, 1991). It raises the issue of governance in two main aspects. The first stems from the growth of managerialism which aims to introduce more expressly commercial styles and

management practices into the public sector. These include: hands-on professional management, explicit performance standards and measures, performance-oriented management, value for money, and closeness to ‘customers’. The second refers to introducing market-based competition, ownership diversification, and consequent need for better regulated (public) service providers (Pierre, 2000; Rhode, 2007, 2010). It stresses: disaggregating bureaucracies, greater competition through privatization and/or contracting-out, and customer choice. For Pierre (2000), while both policy strands stress a ‘steering’ role for governments, they have also remade public service in a different way from previous public administration orthodoxy (see also Osborne and Gaebler, 1992; Bellamy and Palumbo, 2010).

2.2.1.3 Governance as Network Coordination

In relation to NPM, governance also refers to the coordination of public service delivery through networks, partnerships and voluntary organizations. In many respects this makes governance involve managing and coordinating networks of such different actors as labour unions, trade associations, firms, non-governmental organizations (NGOs), local authorities, social entrepreneurs, and community groups. Rhodes (1997) argued that these organizations can be highly autonomous and self-regulating networks where government is only one of many influential actors. For Kickert (1993, p. 275), “deregulation, government withdrawal and steering at a distance ... are all notions of less direct government regulation and control, which lead to more autonomy and self-governance for social institutions”. For advocates of NPM, a self-regulating and society-centred system based on dialogical and bottom-up dynamics is considered capable of assuring the coordination of economic activities without the ‘Hobbesian sword’ of nation-state (Bellamy and Palumbo, 2010).

2.2.1.4 Governance as ‘Good Governance’

Governance gained currency in the field of economic development when national governments and transnational bodies advocated normative ideas of ‘good governance’ to be indispensable for modernity (Bellamy and Palumbo, 2010). Development economists such as Evans (1989, 1995) and Nolan (2007) recognised that, since institutions matter, economic growth requires more than liberating markets, promoting investment, and adopting appropriate macro-micro economic policies. Sustainable economic development is also underpinned by appropriate laws and regulations, socio-political institutions, and values.

Governance becomes ‘good’ within effective frameworks conducive to market activities – stable regimes, the rule of law, efficient state administration adapted to roles that governments perform well, and more self-regulating civil society (Bellamy and Palumbo, 2010; Rhodes, 2010).

2.2.1.5 Governance as Global Governance

This usage of governance lies in the field of international institutions and regimes. It has been widely argued that certain important problems such as climate change, international trading and monetary policies cannot be administrated or contained at the level of nation-state alone (Bellamy and Palumbo, 2010). To address these expansive problems also requires the creation of transnational political institutions such as, but not limited to, the Organisation for Economic Co-operation and Development (OECD), World Trade Organization (WTO), and Association of South East Asian Nations (ASEAN). This raises the issue of how such supra-state agencies and intra-state agreements are best monitored and controlled by different domestic publics. For Pierre (2000, p. 17), “the parcellized government of international problems by a technocracy, interacting with the elites of the major wealthy states, influences the vital life aspects of domestic publics, and yet remain inherently remote from their control”.

While the meaning of governance may sometimes seem too broad to be useful, the concept can be enhanced by encapsulating the common themes deriving from different usages (Rohde, 2010). First, governance denotes the exercise of authority – political, economic, administrative or otherwise – to manage resources and affairs (OECD, 2005c). This can be interpreted at many levels, from the state down to the local communities and/or corporations. Governance analysis thus considers the mechanisms, processes, relationships and institutions through which actors articulate their particular interests and exercise their respective rights and obligations (Bellamy and Palumbo, 2010). Second, governance implies interaction and coordination among various actors to achieve common objectives. The term thus extends beyond the administrative branches of the state to include other actors in society, including private sector, civil society and international organizational actors (Pierre, 2000; OECD, 2005a). Third, good governance implies effective political institutions and responsible use of political power and management of public resources by the state. Governance issues pertain to the nation-state’s ability of sustaining coordination and coherence among actors with divergent interests and goals (Jessop, 1995, 1997). Therefore, it is proposed to define

governance as the system of values, policies, institutions and processes through which relevant actors attempt to work towards common objectives, make decisions, generate authority and legitimacy, and exercise power (Pierre, 2000; OECD, 2005a). While a stipulative definition as such can be arbitrary, it arguably incorporates significant elements as follows (Rhodes, 2007, 2010).

- Expanding the boundaries of governance with a greater variety of actors;
- A more ‘steering’, less monopolistic role for the nation-state;
- Governance as both a constellation of mechanisms and techniques, and leading dynamic among societal actors;
- Governance polity as the result of interactive socio-political forms of governing.

In fact, governance can here be viewed as “the complex art of steering multiple agencies, institutions and systems which are both operationally autonomous from one another and structurally coupled through various forms of reciprocal interdependence” (Jessop, 1995, p.66). For Bellamy and Palumbo (2010), this definition involves the transformation of those institutions which govern socio-economic activities, as their interactions often imply the emergence and rearrangement of different forms of governance (see also Lindberg et al., 1991; Pierre, 2000). It is important to research cross-national variation in governance policies and practices to understand how particular governance quality expresses itself through attributes such as accountability, efficiency, legitimacy and sustainability (Hye, 2000).

2.2.2 Governance of State Sector

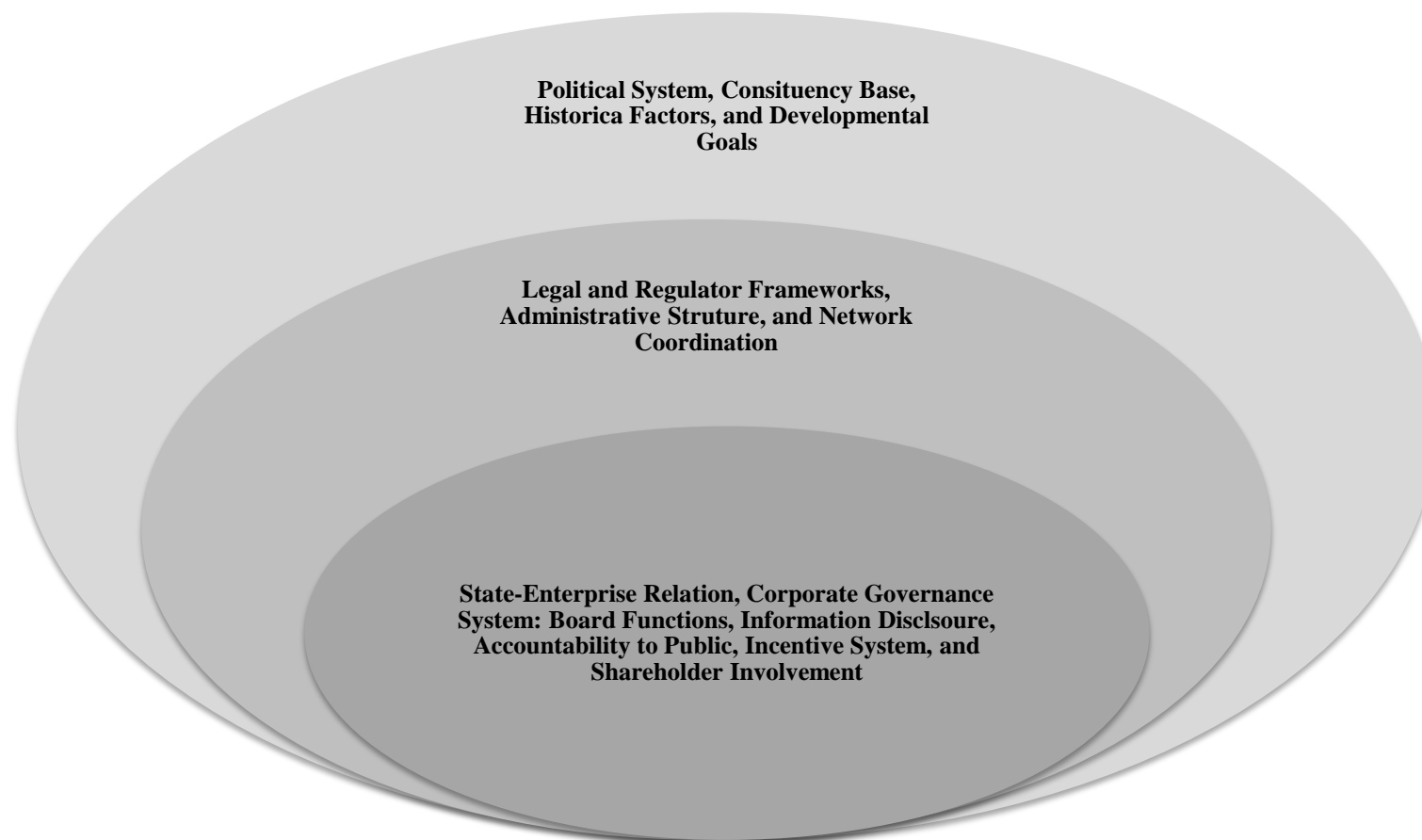
A state sector generally covers a broader range of legal entities – in most cases state-owned enterprises (SOEs) and/or state-controlled corporations (SCCs) – created by the owner state to undertake commercial activities (Carnevale, 2002; Barlow et al., 2010). For both developed and developing economies, the state sector represents a substantial part of gross domestic production (GDP), employment and market capitalisation. SOEs and SCCs are often prevalent in more strategic industries, such as energy, transport, natural resources and banking, whose performance is important to broad segments of the population, as well as

other industrial and/or business sectors (OECD, 2005a; Nolan, 2007).¹ It overlaps with the public sector in that most providers of basic government services have been, or might become, corporatized (Lapsley, 1999; see also Nor-Aziah and Scapens, 2007).

SSG here is concerned with relations between the state and its business entities: how the nation-state steers corporations to achieve desired goals, how it makes itself accountable to stakeholders, and how it guarantees their rights and interests (OECD, 2009b). Therefore, SSG relates to the structure and process of overseeing the direction and management of SOEs and/or SCCs so that they carry out their mandate and achieve given objectives (Hye, 2000; Bevir, 2007). Such governance arrangements provide the structure through which the objectives of these enterprises are set, and “the means of attaining those objectives and monitoring performance are determined” (OECD, 2005c, p. 11). SSG is important because it sets the rules for economic and political interactions between state and market and within the state; it determines which decision-making structures set public policy priorities; it allocates resources to address these priorities. In short, it is at the core of much economic development (Rhodes, 2007, 2010; Bellamy and Palumbo, 2010).

The focus of governance in the private sector is on the board of directors (BODs). In the public sector context, boards are sometimes difficult to identify and define, as they operate in different statutory and managerial frameworks (OECD, 2005a, 2009). In most cases state sector entities are “subject to forms of accountability to various stakeholders ... each with a legitimate interest, but not necessarily with ‘ownership rights’” (IFAC, 2001, p1). Therefore, in its broadest sense, SSG refers to relationships involving organizations and institutions of the state at different levels (see Figure 2.1). These could be between different organizations such as central ministries and local governments, or between state ownership agencies and other stakeholders, or how regulations and orders can be enforced (Rhodes, 2007, 2010). Moreover SSG involves a broader range of socio-political factors in comparison other types of governance. For state sector entities “have to satisfy a complex range of political, economic and social objectives, which subject them to a different set of external constraints” (IFAC, 2001, p. 1). The OECD (2005b, 2005c, 2009) lists five key elements likely to be present in the context of SSG.

¹ In some countries the public sector includes a large number of entities that have been separately established by government agencies to undertake new activities or activities previously performed by core government (IFAC, 2001; OECD, 2009).

Figure 2.1 Aspects and Levels of SSG

Source: Fox and Heller, (2006), Ahrens et al., (2011), and Tricker (2012)

- Traditional administrative, rule-based governance (including the centrally planning systems in former socialist countries);
- Increasingly performance-based governance;
- Network coordination between organizations inside and outside the sector;
- Political-economic factors: formal and informal power and interests and their mode of articulation;
- Historical factors: context specific and path-dependent trajectories through which governance practices have developed.

There are major issues and debates regarding government and business. Rather than being confined to the role as the “gatekeeper” in public administration, the nation-state encompasses more diverse roles and functions in SSG, including asset allocation, corporate management and operation, regulatory enactment and implementation, as well as stakeholder coordination (OECD, 2011b). However, it has been long contended that businesses, even if state-owned, need to be run according to a commercial rather than administrative cycle. This implies that day-to-day management of SOEs and/or SCCs should be independent and commercially-based. Thus the state, often acting as the main (and often the only) owner, should engage management to ensure due performance (Estrin, 1998, 2002). On the other hand, state sector owners may have other objectives besides profitability alone. For economic historians (e.g. Cameron, 1978; Rose and Miller, 1992; Hannah, 1994), nationalisation, which often took place after the Second World War in Western Europe, was originally approved by voters as ‘being in the national interest’, even if that that involved relaxing other market pressures. Other goals were also stressed at the time, including universality of public service, income redistribution and employment promotion. The multiplicity of goals emerging from the political process raises difficulties in monitoring target fulfilment, especially when objectives are defined as “loose long-term goals” (Estrin, 1998, p. 16). Where objectives are arbitrarily decided by different government agents, SOEs generally “suffer as much from undue hands-on and politically motivated interference as from totally passive or distant ownership by the state” (OECD, 2005a, p. 10). The problem becomes more salient where the state sector involves complex chains of agents, including national and local governments, ministries, public investors, and corporate management, with divergent interests (Estrin, 1998). This in turn gives rise to certain repeatedly cited

problems, including (1) conflicts among different government apparatuses, (2) political intervention by officials acting in the capacity of ‘owners’, (3) excessive slack and resource misallocation by corporate managements, (4) soft budget constraints arising from power-responsibility asymmetry, (5) and (6) the pursuit of non-business objectives at the cost of other stakeholders (Alchain and Demsetz, 1972; de Alessi, 1980; Kornai, 1980; Estrin, 2002; La Porta et al., 1997, 2000). The consequences of these problems can be not only loss-making and/or inefficiency, but also a weakened financial system and economic underdevelopment (Megginson and Netter, 2001; Pagano and Volpin, 2005).

2.2.3 Good Governance in State Sector

Concern about SSG is not new: the past two decades have witnessed widespread attempted reforms in consequence. This is due to various factors, including market liberalisation, technological advance, and political reforms calling for readjustment and restructuring (Roland, 1994b; Megginson and Netter, 2001; Nolan, 2001; OECD, 2005c, 2009b). Since early 1990s, transnational bodies have maintained that effective governance of a state sector will “be critical to ensure their positive contribution to a country’s overall economic efficiency and competitiveness” (OECD, 2005c, p. 9). Quest for good SSG suggests that there are different cause-effect relationships between specific repeated practices and desired outcomes (Todd, 2010). First, to the extent that multiple functions induce political intervention, separation of business and social functions delineates power and responsibility between enterprise managers and officials, keeping them accountable for performance (Vagliasindi, 2008). Bertero and Rondi (2000) for example demonstrated this occurring in Italy since the late 1980s when state controlled firms responded to hardened budget constraints and increased competition by increasing their productivity and reducing employment. Second, sound SSG practices, in particular effective CG mechanisms, enhance the confidence of investors and business partners and thus increase SOEs’ potential access to external finance (Cornell and Shapiro, 1987; Richardson and Welker, 2001; Maher and Andersson, 2000). These mainly include strong legal protection and enforcement, effective information disclosure, independent boards, and shareholder activism. A reduced expropriation risk encourages financiers to offer equity or loans at better terms as reflected by a lower cost of capital and higher firm valuation (Megginson

and Netter, 2001; La Porta et al, 2002; Claessens, 2006). Moreover, effective SSG can accelerate economic growth in a context of the structurally weak markets and certain specific ‘catch-up problems’ faced by developing countries (Khan, 2007). It requires growth-enhancing strategies and institutions that promote private and public accumulation, and ensure further productivity growth across different sectors (Levine and Zervos, 1998; Khan, 2007). The key governance goals may thus include (1) “assisting the transfer of assets and resources to more productive sectors using both market and non-market mechanisms”, (2) “managing incentives and compulsions for achieving rapid technology acquisition”, and (3) “maintaining political stability in a context of rapid social transformation” (Khan, 2007, pp. 3-4). Such arguments often point to East Asian success where SSG practices typically amounted to more than just those necessary for ensuring market efficiency alone (see Leftwich, 1994, 1995; Riain, 2000).

Reform typically espouses good governance practices, not least where scandals have brought campaigns for better standards (Howson, 2009). For Scott (2007), SOEs should be conceived and managed within a clearer vision of solving existing weaknesses or problems in the provision of needed services and goods without these solutions also becoming another problem themselves. SSG reform should therefore ensure that SOEs “pursue the objectives for which they were established, preventing mission creep and an institutional tendency to continue to grow in size and expand in scope” (Scott, 2007, p. 4). Transnational bodies (e.g. OECD, 2005a, 2009b, and 2011a) therefore identify these key levers for promoting sound SSG:

- *Separation of ownership from regulatory and other social functions.* The dual role of SOEs as both market players and arbitrators can induce conflicts of interest, in particular when ownership and social functions are vested with the same sectoral ministries (OECD, 2005b).
- *Clear state ownership policies and corporate objectives.* Policies should define a state’s overall objective as the business owner, outline the possible legal form of SOEs and specify the state’s own roles in corporate governance and how they should be effected. With clearer guidelines for corporate management this lessens undue political intervention (OECD, 2009a; Scott, 2007).

- *Ensuring Effective Regulatory Framework.* This provides a level-playing field in the market where SOEs and private enterprises compete on a fair basis. As an essential step to avoid market distortions, SOEs should not be exempt from application of general laws and regulations. Other stakeholders including competitors should have access to proper redress and even-handedness when their rights are deemed to have been violated (OECD, 2005a).
- *Introducing Sound CG and Enhancing Board Functions.* This helps ensure requisite corporate decision-making through holding managers and officials accountable for their actions to more professional and independent SOE boards (Vagliasindi, 2008; OECD, 2011b).
- *High-level transparency.* This means that information about economic conditions, budgets, markets and government intentions is reliably attested and made accessible to a wider public. Insistence upon transparency requires enhanced accountability, limiting corruption, and stimulating cooperation between governments and non-state players (OECD, 2011b).

The prevailing guidelines, nevertheless, are drawn heavily upon the Anglo-American model of CG featured by disperse ownership structure and separation of ownership and control (OECD, 2005a, 2005b, and 2011a). The model is based on normative ‘free market’ principles and relies on various prerequisites for its successful operation including perfect market competition, developed financial market, rule of law, and a regulatory regime of high accountability and transparency. Although compliance with these elements and/or guidelines is voluntary, national policymakers tend to respond to code recommendations due to market forces and peer pressures (Gregory and Simmelkjaer 2002; Aguilera and Cuervo-Cazurra, 2009).² This, however, can be problematic. Firstly, translating approaches developed from the level of organisation to a broader state or public sector can encounter difficulties due to the complexities of the larger system (Halligan, 2001, p. 17). As noted, the reform process for large state sector administration that involves multiple-organisational systems presents distinctive challenges. Secondly, the apparent ascendancy of Anglo-American CG institutions has been profoundly questioned by the scale and contagion of the global financial crisis (Clarke, 2010). Critics refer to overemphasis on self-regulating

² For example, South Korea, badly hit by the 1997 Asian financial crisis, was forced to revamp its traditional governance systems as a condition of financial aid from the international financial community.

markets and minimal regulatory interventions (see Siddiqui, 2010). The devastation of prominent state-backed financial institutions and recurring corporate failures remind the world of the extreme dangers of unregulated markets and institutions, and of the eternal importance of effective regulation, and robust governance. Moreover, to the extent that prerequisites of the model have yet developed in transitional economies, the piecemeal and pragmatic imposition of governance codes and regulations often achieve limited effect. This in turn questions the value of remedial prescriptions drawn from Anglo-American sources alone (Todd, 2010; Bebachuk and Weisbach, 2010; Ahrens et al., 2011).

Saich (2011) maintains that effective SSG involves strengthening or developing institutions, enacting regulations, building administrative and monitoring capacity, and political support. Where reform is mediated by particular institutional characteristics and developmental objectives, SSG often exhibits distinctive national patterns (Hoskisson et al., 2004; Khan, 2007; Vagliasindi, 2008). For Fox and Heller, (2006, p. vii), prevailing interpretation of good SSG lacks the insights to be gained from “examining the much greater deviations in corporate behaviour from the welfare-maximizing norm” which exist outside the US. A multi-equilibrium perspective (e.g. Bratton and McCahery, 2002) further argues that opportunities for efficiency cross-referencing are so limited that significant national variations in SSG systems are likely to persist. The wholesale embracement of Anglo-American model, therefore, fails to explain the striking cross-national variations in state ownership involvement, intervention scope, managerial incentives, and regulatory approaches (see Vagliasindi, 2007).

2.3 Cross-National Variation in SSG

The pursuit of sound SSG reflects changed state-enterprise relationships (Pierre, 2000; Bellamy and Palumbo, 2010). Despite this repeated theme, comparative studies still report striking cross-national variations in strategies to reform governance practices and their outcomes (e.g. Hye, 2001; Berghe and De Ridder, 2002; Chew and Gillan, 2010; see also OECD, 2011b). For the OECD (2005a) also, the rationale for state ownership of commercial enterprises has observably differed between both countries and industries. The comparative analysis of SSG requires identification of the different characteristics of economic coordination and control, of which the

reform strategy is a key variable, direct impacting upon governance systems and practices (see Vagliasindi, 2008). The following discussion proceeds along three key dimensions: reform strategies, sectoral scope, means of control and coordination (see Whitley, 1999; Bevir, 2007; Liao, 2009).

2.3.1 Privatisation and Market-Based Governance

The 1980s accentuated claims that transferring assets from the state sector to private enterprises would raise both allocative and technical efficiency (Yarrow et al., 1986) which almost assumed that states are inherently inefficient compared markets (Vickers and Yarrow, 1991). This was allegedly due to inferior accountability in the absence of real owners, leading to (1) lack of efficiency related incentives, (2) bureaucratic rent-seeking, and (3) political intervention favouring selected constituencies (Perotti, 2004). For Perotti (2004, p. 4), “the free rider problem applies to taxpayers even more so than to dispersed shareholders; moral hazard may be enhanced under state ownership since the powers of government are greater than private management and thus harder to control”.³ In the face of mobile capital and vigorous economic competition, neoliberal-affiliated policymakers and economists argued that state ownership or administration was intrinsically predatory and could best, if not only, be addressed by privatisation (Nolan and Wang, 1999; Estrin, 2002; Bevir, 2007).⁴ This alone would “create(s) a whole new penalty-reward system which will alter the incentives in the firm and ultimately its performance” (Veljanoski, 1987, p. 570; Budds and McGranahan, 2003), while also addressing the taxation issues and cyclical inflation they associated with Keynesian welfare states (Vickers and Yarrow, 1991).

The neoliberalism ideology induced extensive state ownership divestiture across advanced capitalist economies through either wholesale privatisation or functional outsourcing followed (see Clarke and Pitelis, 1995). As a result, the borders of state ownership were dramatically redrawn – over £40 billion of UK state assets have been sold since 1979 and parts of the Civil Service ‘hived-off’ to social agencies effecting

³ Thus there are striking parallels between the governance problems caused by abstract state ownership and diffuse private ownership.

⁴ The long-term fiscal squeeze in many industrialised economies induced governments to revise their governance practices purely on efficient ground (Megginson and Netter, 2001; OECD, 2005).

more ‘commercial management’ (Clarke and Pitelis, 1995).⁵ Dramatic though these reforms had already been, they were ‘overshadowed’ by the privatization wave sweeping the former Soviet Bloc.⁶ Under the Washington Consensus, the term privatisation involved both transferring nominal ownership and control while also transforming complementary political and social institutions (Boycko et al., 1996; Bakker, 2003). German experience further suggested that the radical transformation of ownership and means of production was necessary “to ensure a complete break with the old (socialist) regime” (see Borenzstein and Kumar, 1991, p. 231). An optimistic view that emerging market forces would spontaneously replace state redistributive mechanisms without adverse effects therefore prevailed (e.g. Chang, 2003; Megginson et al., 2004). Privatization thereby became a keystone of state sector reform and socio-economic transition (Estrin et al., 2009).

In the would-be *minimal state*, government ownership only becomes reasonable where market failures occur (Shleifer, 1998). While the scope of state sectors varies across countries, it has often been reduced to natural monopoly sectors and/or provision of non-excludable goods (Stiglitz and Brown, 1988).⁷ In many cases, the term *public sector* is referred to as synonym of *state sector*, where the latter is limited to providing basic government goods and services (OECD, 2005a). Laws and regulations have replaced administrative direction as the preferred form of intervention to ensure equity and avoid market distortion (Rhodes, 2010; OECD, 2011a).⁸ Control is further delegated to special-purposed government agents and/or other civil organizations, encouraging delineation of responsibilities and increasing

⁵ In 1979 public enterprises in the UK accounted for 8 per cent of employment, 10 per cent of output and 5 per cent of gross domestic fixed capital formation. By 1992 the comparable figures have declined to 3 per cent, 3 per cent and 5 per cent respectively (see Pollitt, 2000).

⁶ Experiments in privatizing enterprises in transition economies abound, from extensive efforts at sales to strategic owners (as in Estonia and Hungary), to programs based primarily on insider buyouts (as in Russia and Slovenia), to innovative mass privatization programs involving the creation of large and powerful new financial intermediaries (as in the Czech and Slovak republics and Poland) (see Gray, 1996).

⁷ Some public services, such as health service and education, are difficult to privatize even by the most market-oriented government since “people require access to them regardless of their ability to pay” (Clarke and Pitelis, 1994, p. 14). In these circumstances, attempts have been made to preserve these services in public sector while adopt private sector practices.

⁸ The 1990s witnessed the growth of the regulator states which relies on rule-making, rule-monitoring and rule-enforcement (Glaeser and Sleifer, 2003). Privatization also leads to more diversified ownership structures whereby governments exert limited influence upon enterprise operation. Governance of the privatized enterprises resembles the stylized Anglo-American model that relies heavily upon active financial institutions (see Jensen and Meckling, 1976; Fama, 1980; Williamson, 1983; Demsetz, 1983).

management professionalism (OECD, 2005a, 2011a). The vagueness and ambiguity of state property rights are thus reduced. More detached market exchange and decentralised control imply that enterprises can and should be run on a commercial basis, i.e. maximising owners' interests, as principal-agent theorists advocate (e.g. Jensen and Meckling, 1976; Fama, 1980; Williamson, 1983; Demsetz, 1983). For Bevir (2007), this meant more management by results, performance measures, value for money, and closeness to customers, all tied into budgetary reforms.

All this requires more inter-organizational coordination based on standard market mechanisms and enforceable formal contracts, where organizations need to exchange resources to achieve their objectives, maximize their influence over the outcomes, and avoid over dependence on others (Liao, 2009). It is assumed that the coordination of networks can be sufficiently autonomous and self-regulating to make (central) government only one potential influence (Rhodes, 1997, 2000, and 2007; Bellamy and Palumbo, 2010). Proponents of such a market-based model stress the need to disaggregate bureaucracies and induced more competition through contracting-out, quasi-market and consumer choice.⁹ For them, the state sector can “retain the essential properties of a public service while reaping the benefits of market mimicking” in several distinct ways (OECD, 2008, p. 5). These include (1) raising the quality and “economizing” state expenditure, (2) making public providers more responsive to consumers' preferences, and thus (3) improving resource allocation and budget management efficiency.¹⁰

2.3.2 Alternatives to Privatisation and State-Centric Governance

For Stiglitz and Sappington (1987), the fundamental issue underlying state sector reform is the assumption that enterprises belong to private sphere and governance to centralized planning (see also Megginson and Netter, 2001). Gamble (2000) argued that such an oversimplified dichotomy has neglected other ways for governing state sectors, as if there are no other alternatives to a purely private, unregulated private

⁹ For Kickert (1993, p. 275), deregulations and ownership divestiture would lead to “more autonomy and self-governance for social institutions”. Advocates of this view often point to the success of public sector reform of Britain and Nordic countries (see OECD, 2011a).

¹⁰ These innovations are said to have produced a more effective and efficient polity: “a polity less dependent on command and control logics and hubristic developmental visions, and therefore less susceptible to government failures” (Bellamy and Palumbo, 2010, p. xi).

sector.¹¹ In countries with vestiges of socialist planning, efforts to privatise and deregulate the state sector have proved especially difficult, due to its scale and resistance to reform (OECD, 2012). Moreover, these countries generally lack the essential economic and institutional conditions to support or regulate private activities such that “indeed rapid privatisation may lead to an unacceptable loss of control over the economic system” (Perotti, 2004, p. 14). In such cases, state ownership and intervention prove necessary, if temporary, intermediate supports for social-economic transition. This means adopting a more comprehensive, less dogmatic view of SSG, whose improvement becomes an end in itself, not another move towards outright privatization. This requires policymakers to seek different strategies to improve their performance, including but not limited to private engagement (Megginson and Netter, 2001; Andrés et al., 2011).

In Poland and Hungary, significant improvement in productivity and profitability occurred without large-scale privatisation (see Megginson and Netter, 2001). Pinto et al. (1993) attributed this to reform packages which spanned price deregulation, introduction of foreign competition, and imposition of harder budget constraints reinforced by tighter lending. Competition made enterprise performance more responsive to managerial efforts alone (Vagliasindi, 2007). Groves et al. (1995) discussed how incentives were brought into the Chinese managerial labour market during the late 1980s, including retaining above-quota profit and linking of managerial remuneration to profits. Enterprise autonomy and retained profit increased workers’ incentives and improved enterprise profitability (see also Shirk, 1993; Naughton, 1996). Li (1997) documented marked improvements in the marginal and total factor productivity of 272 Chinese SOEs between 1980-89 arising from a series of partial reforms, including increased use of performance contracts (see also Shirley and Xu, 2001). It was further suggested that much (87 per cent) of productivity increase could be attributed to improved incentives and compensation (see also Megginson and Netter, 2001).

For Megginson and Netter, corporatization alone represents the best policy alternative for enhancing SOE performance without privatisation. It usually involves

¹¹ For Bergloff and Claessens (2006), the pursuit of minimal state and/or privatisation simply neglects the complex web of social institutions and actors where SSG is embedded. All this suggests that certain attributes of good SSG are embedded among broader socio-economic environments where most complementary institutions are still being developed in emergent economies (Tricker, 2012).

commercialisation of activities so that SOE operations are governed by commercial laws like private enterprise (Pannier, 1996). On this basis, governments attempt to provide clear and unambiguous objectives by means of performance agreements that specify respective obligations. Aivazian et al., (2005) compared the performance of 308 corporatized SOEs and 121 non-corporatized SOEs in China and found that corporatization had a significantly positive impact on enterprise performance in terms of profitability and efficiency. For Vagliasindi, (2007), the sources of efficiency engendered by corporatization can be traced to reform of internal governance structures, including the introduction of board mechanisms, expanded managerial autonomy, and administrative streamlining. Corporatisation also altered the incentives and objectives of managers by linking enterprise performance with their evaluation and remuneration (Nolan and Wang, 1999; Bai and Xu, 2005). Continued shareholding control allowed the Chinese party-state to pursue industrial restructuring and fiscal reforms intended to nurture a globally competitive state sector (Nolan, 2007; Yao and Sutherland, 2009).

As noted, the absence of rapid and massive privatisation allows the state to retain its ownership and control over a broader range of business and/or industrial sectors (Wade, 1990). Policymakers take into consideration effects beyond the capacity of private investment, including social unrest and regulatory capture (see Pannier, 1996; Perotti, 2004).¹² In most cases, the state often retains its firm grip over pillar industries or “commanding heights” and makes decisions “on the basis of long-term considerations and these are not and cannot be profit-minded” (Toninelli, 2000, p. 8).¹³ Where commercialization and corporatization imply increasing decision-making power at firm level, the pyramid and cross-shareholdings structure encourage sharing of financial and intangible resources and thus provide additional advantages for SOEs

¹² As regards on-going financial crisis, nationalization of insolvent financial institutions has proved succeeded in preventing the further financial meltdown in both developing and developed economies. The significant state shareholdings provide governments with strong incentives and means of curbing managerial malpractices and improving business performance (see Tian and Estrin, 2005). Thus, in addition to negative externalities and market failures, the opportunistic and fraudulent bank insiders in an unregulated market system offer another rationale for state intervention.

¹³ Groups of large SOEs are preferentially developed through a top-down process and viewed as the driving forces of economic growth and technological catch-up (Toninelli, 2000; Nolan, 2007). Prominent examples include China’s central state-owned corporations since the late-1990s and Korea’s *chaebols* over the 1970s. Their structure typically entails a core, shareholding company converted from a government agent, together with the subordinate member firms in related lines of business (Wu, 2005). Relations among the core company and member firms are often close-knit and expansive, including cross-shareholding, interlocking directorship, financing relations, and joint production (Liao, 2009).

facing outside competition (Pannier, 1996; Liao, 2009; OECD, 2011b). They also enable state control in excess of cash flow rights, thus increasing the risk of investor expropriation (Claessens and Fan, 2003; Wang and Xiao, 2006). Moreover, corporate executives under the state-centric model often encounter the conflicting roles as both government officials and business managers, making performance evaluation and monitoring difficult (Perotti, 2004). Sound SSG here requires complementary governance capabilities which ensure due accountability (Khan, 2007). For developmental economists, benevolent practices by the state (e.g. state developmentalism and state entrepreneurialism) are central to the technological progress and economic growth in newly industrialized countries (NICs) (White and Wade, 1984; Toninelli, 2000; Chang, 2003; Evans, 2004). For Toninelli (2000, p. 8), they can arguably foster “the modernization in the neglected sections of otherwise developed economies or stimulate growth in strategic sectors of the economy by initiating public activities”. All this contrasts with the predatory image offered by neoclassical economists (see Shleifer and Vishny, 1998, 2002). The difference in SSG modes and reform strategies raise some fundamental issues regarding the relationship between the state and economy. In other words, should SSG be best addressed solely in efficiency terms or should it consider other social and political factors? The interpretation and policy prescriptions, therefore, vary not only according to the national and institutional contexts where SSG is pitched, but also the theoretical frameworks employed (Bevir, 2007).¹⁴

2.4 Reviewing Relevant Theories

As shown, the varied meanings of SSG essentially relate to differing interpretations of its *raison d’être*, given the term governance has its own specialist coinage. In this vein SSG reform “has arisen not only as more or less pragmatic responses on the ground, but also as result of sustained theoretical (and even ideological) advocacy by intellectuals and policy makers” (Bevir, 2007, p. 27). Academic interest has latterly become increasingly interdisciplinary, drawing upon both economics and finance and institutional and political economics. This section will now examine two leading conceptions of SSG, namely neoclassical and political economic theories. Any further

¹⁴ The observed cross-national variation suggests that national SSG systems exhibit their specific merits within wider institutional settings. A multi-equilibrium perspective (e.g. Bratton and McCahery, 2002) further argues that opportunities for efficiency cross-referencing are so limited that significant national variations in governance systems are likely to persist.

recognition that not just one but several different modes and/ or techniques of governance are relevant to how the state sector is governed hereafter initially requires the “abandonment of the stark opposition between state and markets” (Gamble, 2000, p. 111).

2.4.1 Neoclassical Theories

Neoclassical economists would ideally conceive the market economy to be a non-state site free from relations of force and compulsion (Bevir, 2007). They have long advocated patterns of governance that marginalize state intervention and instead emphasized the weakness of state ownership compared with private ownership, except for market failures (e.g., Hayek, 1944; Jewkes, 1948; Stiglitz, 1989a, 1989b; Shleifer, 1998; Heath and Norman, 2004). The neoclassical conception of governance as the minimal state expresses a preference for free and spontaneous association of individuals and firms. In the context of the state sector, radical privatization constitutes a critical and common feature of neoclassical theories (Nasser, 2003). The mainstream Washington Consensus views radical and full divestment of state ownership as indispensable for improving governance quality and firm performance. Market economists and policymakers maintain that large, inefficient state-owned plants be closed, and replaced with smaller privatised enterprises. They have thereby emphasized “the importance of competition among (numerous) small firms as the explanation for the prosperity of the advanced economies” (Nolan, 2001, p. 3) while demerging large vertically integrated plants would replace rigid and hierarchical administrative practices with free-market led mechanisms. It is also expected that democratisation, in parallel with broader social transition, might enhance the efficacy and independence of legal and regulatory frameworks. In the neoclassical view, the central task is to regulate industrial structure so as to ensure better competition. Where market economic functioning is introduced simultaneously and comprehensively, mere partial reforms are not enough, and might even become dysfunctional (Murphy et al., 1992; King and Levine, 1993a, 1993b; Dewatripont and Roland, 1995). Drawing upon Bevir (2007), the following section details important theoretical arguments regarding privatisation (see also Vickers and Yarrow, 1991).

2.4.1.1 Market Equilibrium

This argument rests upon the assumption of atomized marketplaces. As the term suggests, atomization assumes that buyers and sellers are relatively unrelated, apart from when transactions occur, so that markets can operate without outside interruption (Granovetter, 1985; MacLeod, 2004). In this perspective, the absence of political and other non-market interference allows individuals and firms to pursue their self-interest, and while actors pursue their interests, others benefit accordingly. Free transactions among firms naturally coordinate diverse economic activities more efficiently than state and other efforts (MacLeod, 2004). Inspired by the classical political economy of Adam Smith, neoclassical economists hold that a free market or *laissez faire* tends towards equilibrium, with price and competition harmonising the numerous transactions of unrelated individuals and firms into efficient resource allocation and optimal production (Friedman, 1982; Hayek, 1994). For Nolan (2001, p. 3), the market equilibrium argument is “deeply suspicious of departures from perfect competition, under which there are large numbers of anonymous firms, none of which can exert any influence on the market”. Privatisation is regarded as the only way to introduce effective competition (Pollitt, 2000). Thus, theoretical arguments for state ownership and control are confined to market failures bringing costly externalities and natural monopolies (Stiglitz, 1989a; Wellink, 1990). Shleifer (1998, p.147) summarized the essence of neoclassical economic arguments thus:

“private ownership should generally be preferred to public ownership when the incentives to innovate and to contain cost must be strong.... [M]any of the concerns that private firms fail to address the “social goals” can be addressed through government contracting and regulation, without resort to government ownership... A good government that wants to further the “social goods”, would rarely own producers to meet its objectives”.

For empirical researchers, comparing pre and post-privatization performance is one method by which the impact of marketization can be assessed. Policies to encourage ownership or control transformation include: denationalization (the sale of state owned assets), deregulation (introduction of other competitive forces), and contracting out (franchising production of state subsidized goods or services to private firms) (Kay and Thompson, 1986; Pollitt, 2000). For example, Bishop and Thompson

(1992) examined how deregulation impacted across British nationalised industries. For industries with greater market openness such as steel, telecom, electricity, and gas, improvement in productivity proved to be more significant than in industries with less competitive conditions. For example, labour productivity growth in British Steel rose from -1.7 per cent per annum to 13.7 per cent per annum, and -2.4 per cent to 8.1 per cent in British Coal (see Pollitt, 2000). These findings were consistent with the extensive literature on deregulation and performance (e.g. Bailey, 1986; Hämäläinen, 2003). For Megginson and Netter (2001), the success of the British privatization program helped persuade other industrialized countries to divest SOEs through public share offerings. The Chirac government of 1986 privatized 22 companies (worth \$12 billion) before being ousted in 1988. Although the returning socialist government did not pursue further sales, it did not renationalize any divested firms either. It launched the two largest French privatizations ever, the \$7.1 billion France Telecom initial public offering (IPO) of October 1997, and the subsequent \$10.5 billion rated France Telecom issue of November 1998. Deregulation and privatization soon spread across other leading European governments through the 1990s, including those of Italy, Germany and, most spectacularly, Spain. Recent research by Modell and Wiesel (2009) has illuminated how different marketization measures, ranging from competitive contracting to conceptions of citizens or users as customers or consumers, claimed significant cost reduction and efficiency improvement in Swedish central government. Using a more comprehensive panel-data set, Hämäläinen (2003) found that deregulation increased the competitiveness/openness of markets across 22 countries, and thus assumed an important role in directly explaining export growth and economic performance.

Notwithstanding the dominant analytical tool for interpreting national economic performance, the core assumptions of the equilibrium argument have been challenged. For example, the assumption that individuals and firms act rationally on the basis of self-interest is an incomplete social-organizing device at best (Arrow, 2012). As Haavelmo (1997) remarked, economic activities are embedded within a web of social institutions and thus influenced by many other factors. However, a more prominent critique asserts that many claims to allocative efficiency are naively based upon perfectly competitive markets (Fisher, 1987; Murrell, 1991). For neoclassical economists, the price mechanism determines the optimum allocation of resources

among various productive uses and the due distribution of services and goods among customers (Shinha, 1995). However, in many developing and/or transitional economies, similarly competitive market conditions and other institutions scarcely exist, and cannot be instantaneously created. Critics of neoclassical economics have therefore contended that it skirts and neglects real-time economic transition and reform, apart from regularly returning to the same theme of static equilibrium with optimum resource allocation (Vickers and Yarrow, 1991; Murrell, 1991; Sinha, 1995; see also Nasser, 2003; Arrow, 2012).

2.4.1.2 Rational Choice

Rational choice theorists seek to explain governance modes and practices by reference to micro-economic analysis of individual actions driven by calculative interests (Bevir, 2007). On one hand, the theory attempts to unpack social institutions and rules entirely by analyses of individual (rational) action. On this basis, it models individual behaviours as if they act in accord with preformed preferences. This requires such preferences to be rationally complete and transitive provided that individuals have full and complete information about the consequences of their chosen actions. Although such unrealistic assumptions can be relaxed by introducing the concept of bounded rationality, the theory generally explains individual actions in terms of complete rationality, especially profit or utility maximisation.

Rational choice theorists incorporate cost-benefit analysis into their idea of self-governing market mechanisms and attempt to explain how market activities become self-regulating and enforcing with minimal influence from nation-state (Pierre, 2000). Unlike new institutional economists, they view governance systems extending across a continuum, of which the two opposing poles are hierarchies and markets (Williamson and Winter, 1993). It is then pivotal for any governance system to find the right equilibrium between direct government intervention and market coordination. For example, Williamson (2012) argues that hierarchical control by the state becomes increasingly untenable in the context of marketization and globalisation compared with the self-regulating contracting in free market (see also Dowding and Dunleavy, 1996). Williamson further identifies two main structures of self-regulating contracting: (1) a bilateral structure that creates incentives for actors to resist opportunistic urges that otherwise destroy the system; (2) unified structures which

integrate transactions vertically under one private owner so as to eliminate any self-interest leading to wider breakdown. In both cases, self-regulating contracting appears to be an efficient alternative to state coercion as a viable way of avoiding “tragedies of commons” (see Hardin, 2010). In this view, the role of state should be limited to eliminating the negative externalities that “otherwise erode cooperation by fostering coalitions and networks from which all the actors benefit” (Bevir, 2007, p.1). Moreover, rational choice theorists conceive of firm size as tending towards an equilibrium position: “at the margin, the cost of organizing within the firm will be equal to the costs of organizing in another firm or to the cost involved in leaving the transition to be organized by the price mechanism” (Coase, 1937, p. 55). For the large corporation, outsourcing non-core assets and business areas has been more prevalent, and received particular attention since the late 1980s when technological advance reduced the costs involved in undertaking transactions with other firms. This trend has been argued to mark the end of large (state-owned) corporations and herald another epoch of production systems based more upon small and medium-sized (private) firms (see Nolan, 2001). These analyses open up the possibility of self-governing network with minimal influence from nation-state. In the case of public sectors in advanced economies, analysts are more interested in exploring specific cases where hierarchical administrative coordination has been replaced by self-regulating networks among more numerous market participants. For example, Rhodes (2010) used the phrase of ‘hollowing out the state’ to summarise key changes in Britain’s public sector, including large-scale privatization, diminished central and local government discretion, and the emergence of more potentially self-organizing networks through outsourcing. As such networks multiply national government’s capacities to intervene and control will erode further. Swedish experience in particular suggested that agencies would “become increasingly independent with their own distinctive culture and marked reluctance to accept central guidelines” (Rhodes, 2010, p. 13).

However, rational choice theory, important as it is, has not yet informed comparative studies of governance due to an (over) emphasis upon cost efficiency and a relatively static conception of governance institutions, whose respective prerequisites have been overlooked (Granovetter, 1985; Shelanski and Klein, 1995; Ghoshal and Moran, 1996). It takes limited account of the nuances of particular economic and institutional

settings, including how different governance systems evolve. Issues of how (self-regulating) institutions and practice emerge, expand, and persist often remain unanswered. Critics also question its optimistic assumptions about market atomisation, where both financiers and managers have full freedom of entry and exit from certain contractual relationships, and continually search for better alternatives (Hill and Jones, 1992). In other words, it neglects the weakly institutionalized environment characterized by a limited number of participants and underdeveloped legal infrastructures. These might well occur among those transitional and/or developing economies which lack due market discipline – disequilibrium raises barriers to entry and exit instead (Bevir, 2007). Recurring scandals and crises in developed economies also suggest that few governance systems are truly self-regulating (Clark and Branson, 2012). So, by regarding self-regulating networks as if almost frictionless and conflict free, this argument may ultimately underestimate the range of relationships through which economic transactions are conducted, and conversely overestimate the effect of network coordination per se.

2.4.1.3 Property and Ownership Rights

The argument of property rights refers to the theoretical construct in economics for determining how assets and/or resources should be owned and used (Demsetz, 1964, 1966, 1967; Kay and Thompson, 1986). The core bundle of property rights includes (1) the right to utilize the asset, (2) the right to possess the benefit (and responsibility for the negative outcomes, such as damages and debts) of utilization, and (3) the right to transfer the asset through gift or sale (Kay and Thompson, 1986; Putterman, 1995). This bundled concept applies not only to discrete assets such as machines and buildings, but also to business enterprises, which are simultaneously both the property of persons or other entities, and also entities empowered to act as legal agents in their own right. In the case of private property, owners have exclusive rights of using and benefiting from the resources they own, as well as transferring to others at whatever prices are mutually agreeable. For de Alessi (1987, p. 26), the stronger the private property rights are, i.e. more carefully defined, allocated, and enforced, “the closer is the relationship between the welfare of the owners and the economic or social consequences of their decisions and the greater is the owners' incentive to take account of the harms and benefits that their decisions visit on others”. However, the

separation of ownership and control – common among many large modern corporations – raises issues of incentive incompatibility and information asymmetry between owners and managers. While agency problems, such as the moral hazard and managerial slack and discretion, may surface, principal-agent theorists assert that managerial opportunism and the related costs can be resolved via various governance mechanisms (Jensen and Meckling, 1976; Fama, 1980; Williamson, 1983; Oviatt, 1988). As they cannot capture the full gains from any investment they might undertake, they generally have to increase their productivity or else conserve them (de Alessi, 1987). For large state-owned plants, where most ownership rights are delegated to the bureaucratic apparatus, managers can encounter ambiguous or contradictory goals from having multiple principals at the intermediate level. For Stiglitz (1989a, p. 32), “managers can always claim that the reason they are losing money is not that they are inefficient or incompetent, but they have been pursuing other goals”. It is virtually impossible for various supervisory or controlling organs in the bureaucratic apparatus to distinguish between policy-induced losses and those caused by managerial malpractices. The abstractness of the real owner and ambiguity of multiple goals affords managers scope to evade accountability for their own professional failings (Heath and Norman, 2004). The asymmetry between power and responsibility further implies that resources under state ownership are less likely to be allocated to their highest-valued use, provided that private ownership is economically feasible (de Alessi, 1987; Heath and Norman, 2004).

Empirical studies of privatization to date often consist of firm-level econometric comparisons of the pre and post-privatization financial or operating performance. For example, Megginson et al. (1994) examined the profitability and productivity improvement of 61 firms across 18 countries and 32 industries which underwent full or partial privatization from 1961 to 1990. In addition to a revealed reduction in leverage ratio and government subsidies, there were significant increases in profitability, output per employee, capital spending, and employment following both full and partial ownership divestiture. The findings were consistent with Ehrlich et al. (1994), which demonstrated a positive correlation between private ownership and productivity growth as well as cost reduction over the long term. Dewenter and Malatesta (2001) examined whether the profitability, leverage, and labour intensity of the privatized firms in the 500 largest international companies, as reported in Fortune

Magazine for 1975, 1985, and 1995, outperformed those state-owned firms in the heterogeneous group. After controlling for specific firm size, geographical, industry, and business-circle effects, their statistical analysis provided robust evidence that privatized companies had statistically higher profitability, lower levels of indebtedness, and fewer labour-intensive production processes than the state-owned counterparts.

The merits of the ownership argument stems from its analytic simplicity – its abstraction of two distinct parties, i.e. principal (owners) and agent (managers), which affords insights into important but once-neglected features such as information asymmetry, goal conflicts, and differing attitudes towards risk. However, as the interests of stakeholder groups are reduced to just two different parties at firm level, the argument can overlook subtle but important interactions among each different stakeholder. Emirbayer and Goodwin (1994) deemed a bilateral contractual relationship between principals and agents to be a type of “dyadic reductionism” which struggles to recognize multiple “principals”, let alone how any conflicting interests are resolved (Wei, 2003, pp. 44-45). For the management of privatised firms, incentives for profit maximisation and cost reduction rely upon CG mechanisms to be the key means of aligning otherwise divergent interests (Daily and Dalton, 2003; Denis and McConnell, 2003). Where essential prerequisites, such as active takeover markets and stringent regulatory oversights, remain underdeveloped, the efficacy of privatization schemes diminishes, as found in developing and transitional economies (Allen and Gale, 1999; Frydman et al., 1999; Megginsom and Netter, 2001). In fact, the argument has been criticised for retaining a ‘thin’ view of the actual socio-economic environment influencing particular reform sequences and institutional governance design (Aguilera and Jackson, 2003).

2.4.2 Political-Economic Perspectives

Variations among governance systems and reform outcomes are here explained by the underlying political-economic dynamics (see Roland, 2002). While governance practices can reflect laws and regulations, politics determines much about the legislative process, and public policy choices (Pagano and Volpin, 2005; Gourevitch and Shinn, 2009). The significance of the politics behind SSG is most obvious with respect to not only types of investment made, but also how gains become distributed,

and what long-term goals get achieved (O’Sullivan, 2001). Structural adjustment inevitably gives rise to both winners and losers (Leftwich, 1994, 1995; Naughton, 1996). For Gourevitch and Shinn (2009, p. 3), governance structure “affects the creation of wealth and its distribution into different pockets”. It is no wonder that SSG reform provokes conflicts, particularly in regard to outcome uncertainty (Dewatripont and Roland, 1995, 2000; Pagano and Volpin, 2005; Campos and Horváth, 2012). As Gourevitch and Shinn (2009, p. 3) stated, “anything that shaped wealth, opportunities, stability, and corruption is sure to attract the concerns of the powerful and provoke the anxiety of the weak”. In short, redistributive reform can be opposed by entrenched interests (Roland, 1994b; Shirk, 1993). The practical challenge of reforming a state sector includes how to manage politically any major redistributions of capital and power involved during structural transformation (Shirk, 1993). What appears clear from the experience of developing and/or transitional economies is “the ability to plan and implement adjustment was largely a consequence of both political commitment, capacity and skills, as well as bureaucratic competence, independence, and probity” (Leftwich, 1994, p. 367; see also Healey and Robinson, 1992). In search of more profound factors, political economists therefore argue that state sector reform is “fundamentally a political matter and that it is illusory to conceive of good governance as independent of the forms of politics and type of state which alone can generate, sustain and protect it” (Leftwich, 1994, p. 363). For them, sound SSG is intimately related to broader economic, social and political factors, in particular the role and capacities of the state (Saich and Saich, 1981; Saich, 2004). In this vein, they examine and compare different socio-economic causes and conditions which enable the state to conduct certain developmental actions but not others (Nordlinger, 1987; Leftwich, 1994, 1995).

2.4.2.1 State Developmentalism

The notion of *state developmentalism* or *developmental state* seeks to explain the state’s (positive) role in East Asia’s unexpectedly extraordinary post war economic development (Robinson and White, 1998; Johnson, 2010). Economies within this region, often referred to as NICs, originally embraced free market-defying selective industrial policies through powerful state agencies and/or total state ownership (Fine, 1999; Johnson, 2010). The locus of this theory is a developmentally-driven nation-

state, consisting of government bureaucracies and SOEs, “whose politics have concentrated sufficient power, autonomy and capacity at the centre to shape, pursue and encourage the achievement of explicit developmental objectives, whether by establishing and promoting the conditions and direction of economic growth, or by organising it directly, or a varying combination of both” (Leftwich, 1995, p. 401; see also Öniş, 1991; Evans, 1995). The theory pragmatically regards the best arrangement of state sector as that which would more rapidly produce national prosperity amid hostile international competition. The free market and centralized planning were each regarded as inadequate for this task (Nolan, 2007). Compared with the model of regulatory state, a developmental state intervenes more directly in the economy through a variety of means to pursue industrial policies and reduce investment dislocations (Öniş, 1991).

The ‘classic’ developmental state was an ideal type derived from the Japanese experience between the 1950s and the 1980s. There are of course cross-national variations. In the case of Japan, there is less direct government ownership of industry, but the private sector was (administratively) guided by the ruling government apparatus, most notably the Ministry of International Trade and Industry (MITI). These government agents consisted of bureaucratic elites who were not necessarily elected officials and were accordingly less subject to influence by either the corporate groups or labour unions through the political process. This originally allowed government ministries greater autonomy to conduct strategic economic planning and look towards long-term national interests without being disrupted by other rival short-term or narrow interests. South Korea went even further than Japan: an extremely powerful pilot agency, i.e. the Economic Planning Board (EPB), actively encouraged the growth of large business conglomerate, the *Chaebols*, by means of protected domestic markets and low interest credit from the state-owned banking system (Chang, 1994; Nolan and Wang, 1999). While the (similarly US influenced) Taiwanese government had elsewhere intervened less forcefully, the extent of its direct state ownership of large-scale heavy industry was even wider (Wade, 1990). Such state control and leadership focused on vital upstream industries ranging from synthetic fabric to metal processing, which in turn strongly influenced the private sector. It is noteworthy that even in sectors where SOEs did not dominate, such as plastic and textiles, the state “aggressively led private producers” using various

measure including import controls, tariff, domestic content requirement, and concessional credit (Wade, 1990, p. 10; also Nolan, 2007). Singapore used yet another model incorporating free trade, foreign direct investment, and a significant state sector – one of the biggest in the non-oil-producing world, once accounting for more than 22 per cent of GDP, when the global average approached 10 per cent (see Chang, 2010). A state-owned investment corporation, Temasek, controlled a broad spectrum of sectors including financial services, telecommunications, media and technology, transportation and industrials, life sciences, consumer, real estate, as well as energy. While SSG governance necessarily encompasses bureaucrats, technicians, and other functionaries (Hye, 2000), these different national examples highlight the central role of nation-states in first “supporting the emergence of modern industrial corporations ... which could have formed the basis of prosperity in other parts of the economy” (Nolan and Wang, 1999, p. 180).

Although the political and institutional structures of these states were development directed, the foremost objectives of SSG were often politically-driven. For Leftwich (1994) the important factors normally included nationalism, external threat, 'catch up' with the west, and regional competition. Woo-Cumings (1999) traced the historical origins of developmental states to broader colonial and postwar leanings towards secure national development self-determination. Security issues were pronounced where Taiwan faced the mainland communist regime. The Nationalist Party or *Kuomin Tang* had to justify its very existence in this light (Leftwich, 1994). It is further argued that this nationalistic vision and unique commitment to long-term economic growth enabled ruling elites to bypass income distribution and social welfare related issues. The pull of nationalism in calls for 'catch up' and 'getting even' led Johnson (1995) to question how important their domestic economic take-off phase alone really was. For Chang (2010) this particularly underscored ownership control and regulatory intervention in large business conglomerates. Large state-owned businesses were disproportionately important among more capital intensive and other upstream sectors. For Nolan and Wang (1999) intervention in state ownership and/or regulation has been also been consequential. Far from simply emerging through free markets many leading corporations also have relied upon extensive government support at particular stages in their cycle (see also Nolan, 2007).

2.4.2.2 State Entrepreneurialism

While neoclassical scholars focus upon profit seeking and exploiting opportunities among private enterprises, political economists would argue that these same practices are realized through government as well (Yu, 2003), and are best termed entrepreneurial rather than rent-seeking, corruption, predation, and related interventions (Duckett, 2002). The term *state entrepreneurialism* therefore presages how the proactively entrepreneurial state (Mazzucato, 2011) becomes the catalyst for more innovative governance and business practices (Duckett, 2002). In particular it refers to state agencies and/or local governments characterised by entrepreneurial activities for profit seeking purposes (Blecher and Shue, 2001). The SSG practices here entail the following important features.

- State entrepreneurial involvement in business by state bureaux and local governments. Leading officials create new business ventures which require making business decisions on agencies' behalf and investing government funds in the same way as private entrepreneurs (Yu, 2003);
- State led pursuit, and further justification, of due profit-seeking, making and distribution;
- Entrepreneurial bureaux and local governments conduct business in an individual capacity for their own ends even where this requires competing with each other;
- They also take and manage risks in the sense that they stand to lose their investment where success and profitability are not guaranteed;
- An entrepreneurial state is adaptive where officials change codes and conduct in line with differing socio-economic contexts. This includes re-deploying state officials and staff in the course of state restructuring and market transition;
- State entrepreneurialism differs from bureaucratic profiteering or rent-seeking because it is more potentially productive than anything the *predatory state* would envisage (see Lu, 2000).

Castells (2010) argues that, in early economic take-offs, NIC governments (particularly in South Korea, Taiwan, and Singapore) assumed more entrepreneurial roles via public corporations and state investment agencies (see also Nolan and Wang, 1999; Yu, 2003). For Lichauco (1988, p. 111) such governments were “not only as the source of economic policy, but also as the proprietor, entrepreneur and operator of

industrial and commercial enterprises”. Entrepreneurial states have been notably attentive to, and taken well-coordinated actions about, their chosen/target industrial sectors, and pursued 'governed markets' for further development purposes (Weiss and Hobson, 1995; Henderson and Appelbaum, 1992; Wade, 1990). In some cases, they invested heavily in new technologies, usually by setting up government research and development facilities before transferring the results to both state and private companies, and without necessarily transferring the associated development costs in the same way. For example, Hyundai and Samsung Heavy Industries, now leading global players, drew upon earlier state initiatives including subsidised credit, domestic market protection, and internationally sourced specialist technical assistance (see again Weiss and Hobson, 1995; Yu, 2003, Mazzucato, 2011). Officials have also acted like private entrepreneurs in that, where economic policies first demonstrably faltered, they have often been quickly discontinued or reversed (Luedde-Neurath, 1988). For example, the Singapore government embarked upon wage correction policy in the late 1970s, aiming for substantially increased income levels, but when this was later found inappropriate, an immediate wage freeze was implemented to counter further possible recession (Blecher and Shue, 2001; Yu, 2003).

State entrepreneurialism challenges orthodox privatization and the minimal state view by demonstrating how governments can adapt and even contribute to governed marketization by facilitating further state restructuring (Duckett, 2001). For political economists, successful SSG may also arise from the entrepreneurial conducts by government agents. The proactive role of state thus goes beyond creating the right environment for growth and stimulating demand (Mazzucato, 2011). In most cases, both arguments, i.e. state developmentalism and entrepreneurialism, are jointly used to explain relative success of SSG in NICs. Certain essential institutional elements are nevertheless unaddressed (Hochstetler and Montero, 2013). A major role for the state is announced, but the necessary institutional and social conditions for its discharge are insufficiently identified (Leftwich, 2010). Concern about “bringing the state back in” did not always fully engaged the political determinants of its autonomy and capacity, and in particular how the leading actors response to the changing socio-economic environments in their own ways (Skocpol, 1985; Leftwich, 2010; Chang, 2010; Hochstetler and Montero, 2013). Hochstetler and Montero (2013) argued that inability to analyse the *anatomy* of the developmental or entrepreneurial state has been at fault.

Flawed institutional explanations sometimes allowed neoliberals and anti-statist theorists to deem state failure almost inevitable and then seize theoretical and policy initiatives following the 1998 Asian Financial Crisis (Leftwich, 2010; Chang, 2010).

2.4.2.3 Political Economy of Gradualism

In addition to developmental goals and conducts, there are unresolved issues concerning the most optimal speed and sequencing to effect meaningful improvement in the state sector (Martinelli and Tommasi, 1997). In many transitional economies, continued state influence and mediated effects of marketization in SSG practices can be best explained by the gradualist approach employed. The *gradualist* argument anticipates a sequential and piecemeal implementation of reform programmes as opposed to ‘big bang’ or ‘shock therapy’ approaches (Roland, 2002). Such limited or partial liberalisation seeks to maintain the state's influence over business sectors (Wei, 1997; Roland, 2002). Gradualists, who emphasize institutional and political factors as opposed to ahistorical abstract economic theory, contend that Europe's post-war recovery and later economic take-offs among the NICs stemmed from appropriate sequencing by the state (e.g. MacMillan and Naughton, 1992; Hall and Elliot, 1999). For them, the disappointing performance of privatized sectors and popular discontent about radical transformation expose the limits of related shock therapy (Kregel et al. 1992; Wei, 1997). Moreover, if state sector reform in formerly planned economies offers such widespread benefits, why then are reforms with this many winners and so few losers so politically difficult? Proponents here maintain that more gradual reform has the following five principal advantages, which helps explain why politicians so often choose it (Dewatripont and Roland 1995). First, recessions prolonged transitions themselves, making thoroughgoing privatization less favourable. In former socialist economies, they were attributed to the need to first reallocate resources away from certain industries and trade patterns originally inherited from the centrally-planned era.¹⁵ For Popov (2007) this included over-militarisation and over-industrialisation, contrived trade flows among former Soviet republics, and underperforming industrial plants and agricultural farms. Such problems were more pronounced among former Soviet Union than in Eastern European countries, irrespective of China and Vietnam,

¹⁵ Transformational recession, to put in economic terms, was caused by adverse supply similar to the one experienced by Western countries after the oil price hike in 1970s, and similar to post-war recession caused by conversion of the defence industries.

and inevitably extended the period of transition while also making policy implementation more difficult (Roland, 2000; Pei, 2009).

Second, the depth and length of transformational recession were exacerbated by institutional collapses associated with bang approach approaches (Popov, 2007). Where democratisation preceded economic reforms under shock therapy there were too few institutions able to enforce necessary laws and regulations (Zakaria, 1997). This could produce ‘illiberal democracies’ – countries where competitive elections were introduced before the rule of law had been established. Governments of these ‘illiberal democracies’ were deprived of the authoritarian instruments which formerly ensured legal order, but still lacked all the mechanisms needed to guarantee property rights and laws, collect taxes and contain the shadow economy. For Popov, (2007) gradualist reforms in China and Korea were associated with the authoritarian regimes which maintained essential institutional frameworks while still bringing newer market institutions into existence (see also Shirk, 1993).

Third, as regards the initial cost of reform, gradualism helps avoid excessive fiscal burden, and thus enhances the sustainability of reform (Dewatripont and Roland 1995; Qian and Roland, 1998). Where the number of losers from partial reform is limited, compensation costs are made more manageable, and government becomes more credible in consequence (Roland, 1994a; Shirk, 1993). Through improving efficiency in certain sectors first, it can also produce more overall social benefits that in turn enhance the political sustainability of reform (Wong 1992). By comparison, outright privatisation often creates too many losers at the same time, not least regarding massive lay-offs. It thus incurs enormous compensations costs that the government may have no credible means to pay. Failure to compensate losers often causes excessive reduction in living standards, and thus arouses fierce opposition from the mass, making them politically less sustainable (Pei, 2009, p. 22).

Fourth, gradualism allows greater flexibility by enabling more trial and error and also midcourse adjustments (Roland, 2002). Uncertainties about transition make actors reluctant to accept reforms “that may turn out to give disastrous outcomes and moreover be hard to reverse” (Roland, 2002, p. 32). Thus gradualism can make reforms easier to initiate because it retained the possibility of early reversal at lower cost (Dewatripont and Roland 1995; Martinelli and Tommasi, 1997). It is indeed less

costly for the population at large to experience a crackdown on limited segments in an otherwise unreformed economy than it is to reinstate price controls and renationalize (Roland, 2002). Moreover, gradualist reformers can target certain sectors for breakthrough reforms and thus acquire valuable experience and knowledge for applying reforms in other spheres (Rawski, 1995; Roland, 2000; Benczes, 2011). By making – and correcting – policy errors, policymakers are more able to avoid costly mistakes that can fatally undermine the support for reform (Pei, 2009). From an ex-ante point of view, the high reversal cost of negative outcomes makes any big-bang approach politically doubtful (Dewatripont and Roland 1995).

Finally, as a classic strategy of divide-and-rule, gradualist approaches may expand the constituency base for reformers by creating initial beneficiaries which further divides opposition (Dewatripont and Roland, 1995; Shleifer and Triesman, 2000; Pei, 2009). Fidrmuc (2000) found that support for reformist parties in Czech Republic, Slovakia, and Hungary to be positively affected by the existing size of private sectors and higher proportions of white-collar workers or those with university education. Thus a sequential and piecemeal reform can create more momentum by strengthening constituencies during the actual transition process. By comparison, populace are often confronted with large-scaled layoffs and dramatic recession under a big bang approach. These inevitably undermine popular support and may unnecessarily lead to costly reversal (Dewatripont and Roland, 1995; Pei, 2009).

2.4.3 A Political-Economic Perspective on Chinese SSG: Static versus Dynamic

As noted, neoclassical arguments can overlook certain important socio-political factors – ranging from the state's multifaceted role to the potential endogeneity of reforms to ex ante political oppositions (Roland, 1994a, 1994b; Megginsom and Netter, 2001) – which have particular bearing upon policy outcomes (Vickers and Yarrow, 1991; Allen and Gale, 1999). As SSG reforms increase, it becomes important to study different institutional settings in order to understand what makes any particular transition distinctive (e.g. Hoskisson et al., 2000; Wright et al., 2005; Le and Buck, 2009).

The prevailing idea of (sound) SSG is still relatively recent and not native to China, having often been imported into, if not obliged upon, East Asia following the 1998

crisis (Ritchie, 2008). Later studies (e.g. Xi, 2006; Berkman et al., 2012) of Chinese SOE reform duly investigated the mediating influence of political institutions. For Liu (2006), the Chinese SSG system reflects incremental changes where central policymakers and other political agents have been particularly influential. To better appreciate China's emerging SSG problems it is important to recognize that its transitional nature is significantly different from its more developed counterparts. In addition to different redistributive effects and outcome uncertainty, there are distinct political factors underscoring Chinese SSG reform. Foremost, unlike those transitional economies where incremental reform and marketization have been accompanied or preceded by political democratization, China has maintained political continuity as its prevailing authoritarian regime remains relatively intact (Naughton, 1996; Qian, 1999; Lin et al., 2003). The resounding reform success has provided the ruling elites with even greater resources to preserve the status quo and stave off democratisation (Yang, 2006). For Shirk (1993) the pursuit of economic modernisation without political reform meant that policies were "hammered" out among established authoritarian bureaucracies. In other words, policymakers' chosen path was not random but "laid out for them by the incentive and rules of the games of Chinese political institutions" (Tenev and Zhang, 2002, p. 336). To the extent that this authoritarian system is perpetuated, policy outcomes manifestly demonstrate the logic of leading political institutions at work. The lack of a well-defined reform strategy or concrete blueprint questions purely economic reasoning about this (Lin et al., 2003; Nolan, 2007; Naughton, 2008). In debates about the timing and sequencing of reform schemes, political factors have been used to justify the particular choice of strategy and related policy outcomes, and their importance accordingly requires more consideration of political constraints (Tomasic, 2010).

On the other hand, where political autocracy continues, the political logic driving economic reform is based less upon coalition building than central regime survival (Pei, 2009). For the Chinese party-state, the state sector represents a vast patronage system to secure support from key constituencies – the CCP has around 5.3 million officials, or 16 per cent of its members, holding executive positions in the state sector. Radical market-oriented reform can reduce key constituency support, where privatization could lead to mass layoffs that further destabilize one-time communist strongholds where cadres and managers would lose their esteemed privileges

(Schucher, 2009). Therefore the advantages of a gradualist strategy appears self-evident to the authoritarian regime where it helps retain control over vital sectoral developments. In the 6275 large and medium-sized SCCs classified as restructured as of 2001, the party-state owned on average 60 per cent of outstanding shares and appointed 70 per cent of board members (see Fan et al., 2007). For financial economists, most chronic governance defects such as political intervention and managerial slack arise mainly from the state's reluctance to relinquish the control (Bai et al., 2004; Pei, 2009). In essence, if Chinese SSG is as much a social and political as well as economic process, then further research must and will accordingly reflect it.

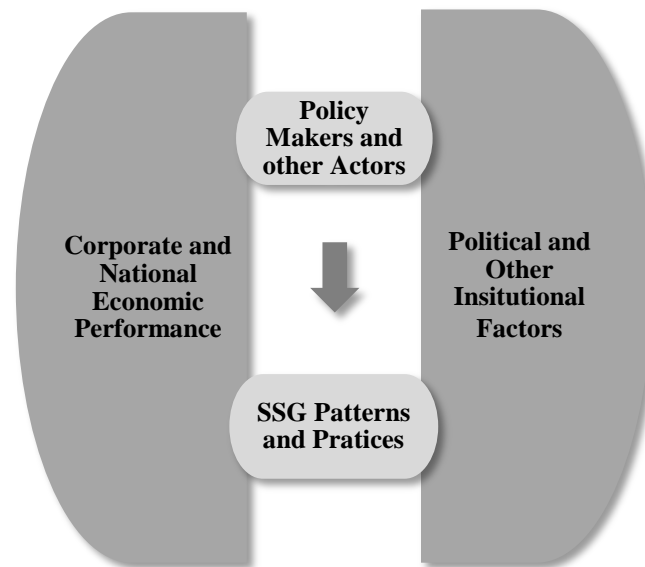
The discussion so far underscores the centrality of politics in explaining the distinctiveness of national SSG systems. Small wonder, then, that SSG practices are likely to be constrained and structured by the peripheral institutions and influential past (Hall, 2010). For Streeck (2009), an overemphasis on structural and historical embeddedness may risk overstating the constraining effects, and thus understate the potential of meaningful transformation (see also Mahoney and Thelen, 2010). For example, Pei (2009) argues that, the gradualist reform in China's state sector involves significant hidden costs and persistent inefficiency under the autocracy's overriding goal of self-perpetuation. In this vein the current governance model will be ultimately imperilled by the increasing rent dissipation and mounting inefficiency incurred by path-dependent partial reform (see Pei, 1994; Rawski, 2001). The inherent self-destructive dynamics will most likely lead to the build-up of systematic risks and progressively attenuate the economic and political vitality of China's state sector, as exemplified by the failures of other self-styled developmental autocracies (see Kim, 1999; Pang, 2000). On the other hand, reform under the gradualism logic involves significant side-payments or concession to potential "losers". In the lights of growing vested interests, sceptics believe that China's state sector reform gradually crystallizes into a "crony capitalism deadlock" that halts further reforms (Duckett, 2002; Li and McElveen, 2013). Economists and commentators even term the leadership of Hu Jintao as the "Chinese lost decade" given the absence of any structural transformation (see Li and McElveen, 2013). This prompts growing concerns that China's state sector reform will inevitably enter a prolonged period of *stagnation* while maintaining a deteriorating *status quo*. According to Pei (2009, p. 10), "symptoms of a *trapped transition* have become highly visible or even pervasive" (see also Yang, 2006).

However, such static assertion appears increasingly counterintuitive; and the more so the longer one looks at the reform trajectory of China's state sector. For many, China's enterprise reform, in particular, the formation of national champions, has close links with socio-economic transition (see Nolan and Wang, 1999; Yao and Sutherland, 2009; Lin and Milhaupt, 2013). It involves distinctive policy motivations including streamlining administrative control (Lin and Milhaupt, 2013), optimising industrial structure (Noland, 1995), securing scarce resources (Yao and Sutherland, 2009), and enabling industrial growth (Nolan, 2007). It is not apparent that current large SCCs sprang fully from pre-specified blueprints (Naughton, 1996). Rather they resulted from policy experimentation and innovation ranging from the expansion of enterprise autonomy to the promotion of the 'going out' strategy (Naughton, 1996; Noland and Wang, 1999; Lin and Milhaupt, 2013). These reforms reflect policy makers' responses to competitive pressure from market liberalisation and globalisation (Nolan, 1999). Recent research often points to the proactive involvement of the central and local governments in reform design and implementation (e.g. Naughton, 2006; Nolan, 2007; Saich, 2011). The ruling elites have been actively mobilising other actors and institutional recourses to overcome entrenched beneficiaries' resistance, and thus help break the previous partial reform equilibrium (Hall and Thelen, 2009; Pei, 2009). For them, any improvement in sectoral performance and governance quality could yield significant political dividends and enhance the party-state's ability to continue to allocate rents to favoured interests and maintain the loyalty of their different constituencies (Pei, 2009). Thus there is no reason to assume China's enterprise reform would be doomed to stagnation (see Yang, 2006).

Given these "anomalies" further research needs to go beyond the static focus upon efficiency and embeddedness (Feng et al., 2011). More attention should be directed towards the "second-order problem" of explaining when and how China's SSG institutions change (see Hall, 2010, p. 204). A more dynamic, political-economic perspective would pursue espoused changes in SGG in terms of whether and how those enacting them actually do so. Its potential usefulness is also evident in studies ranging from individual organizations (Pagano and Volpin, 2006) to economic governance systems (Streeck, 2009; Amable et al., 2010; Richardson and Eberlein,

2011) and, as Figure 2.2 illustrates, this also encompasses the defining “characters” of SSG system in terms of both economic rationale, and political embeddedness.

Figure 2.2 Political-Economic Conceptualization of Chinese SSG



2.5 Summary

This chapter has argued that Chinese SSG needs to be better contextualized to better illuminate and explain its political–economic embeddedness in principle and practice. While its espoused economic rationale clearly matters, so also does its institutional and political enactment, because this is what made Chinese SSG so particularly distinctive. China’s unique political-economic setting itself implies that such reforms’ stated economic rationale has been distinctively mediated by communist bureaucratic institutions which have few parallels elsewhere. The introduction of political-economic perspectives here strives to overcome the stylised dichotomy between economic liberalism and coercive central-planning. However, a (modernised) SSG regime with Chinese characteristics is only just emerging and not yet completed (Tricker, 2012). The discussion here suggests that specified institutional factors exert mediating effects upon, and even impose serious obstacles for, continued reform. From a political-economic perspective, the question is what direction has and will such reform now take? More specifically, will it be locked into structural and historical embeddedness, or could it continue to evolve differently instead? Moreover, regardless of the answer, what are the key social actors and their roles? Are they

leading reform or else just going along with it? How do they shape and advance their own interests within different institutional constraints? These questions deserve further consideration since neither economic impetus nor institutional determinants immediately convert into detailed governance practices. The following chapter will now seek a model to explain the possible and actual paths or trajectories which the Chinese SSG system might follow.

Chapter 3

A Path-Generation Perspective on Chinese State Sector Governance

3.1 Introduction

Comparative research incorporates political and related institutional factors into analyses of cross-national variances in state sector governance (SSG). Such factors are held to be independent or intervening variables for explaining specified policy outcomes at one particular point in time. This poses the issue of "what a SSG system is now like" and not just "how it evolves and changes over time". It assumes governance systems were originally constructed within a particular economic-political context and, once further established, subsequently exhibit an "enduring" or/and "constraining" logic of institutional (pre)determinism (Hay, 2005). This, however, raises the question: if emerging governance practices are, as political scientists argue (e.g. Roe, 1997; Gourevitch and Shinn, 2005), intrinsically rooted in socio-political institutions with the power to oblige enterprises and government agents to conform, how can different new systems and practices subsequently emerge (see Seo and Creed, 2002)? A path-generation approach suggests that the salience of political determinants would not necessarily obstruct the transformation of SSG institutions per se. This chapter now explores the different sources and modes of transformation which this approach takes into account. It puts a wide range of institutional changes into more specific thematic contexts by exploring: (1) why a path-based approach is needed, (2) what explains institutional continuity in SSG, (3) the primary sources and modes of any further transformation,¹ and (4) the roles of social actors in them. It relates both path-dependence and path-generation perspectives to ongoing governance reform in China's state sector, and then presents research propositions derived from such, and their further theoretical and methodological implications.

3.2 A Path-Based Approach

Like other institutions, SSG systems only persist if, and to the extent that, they continue to be produced and reproduced (Giddens, 1979). In explaining the distinct variety of national SSG systems, scholars embrace a process or "path-based" view (e.g. Rowthorn and Chang,

¹ This refers to two distinctive but interrelated stages of institutional transformation – the "deinstitutionalization of extant practices and norms" and the "emergence and diffusion of new institutional arrangement" (Thelen, 2009, p. 16).

1994; Clarke and Pitelis, 1994) which considers how their initial origins impact upon their later form and conduct (e.g. Pannier, 1996; Hirst, 2000; La Porta et al., 1997, 1998, 2002; Aguilera and Jackson, 2003). Here past origins become “a source of empirical material” (e.g. panel-data analysis or multiple case studies) rather than “a spur to serious investigation” of prevailing governance practices (Pierson, 2011, p. 4). Despite contentions that “history matters” (e.g. Gilson, 1996; Schmidt and Spindler, 2002; Clarke, 2004), limited attention has thus far been given to the temporal or evolutionary character of different SSG systems. Moreover certain key concepts regarding reform, such as path dependence, critical juncture, sequencing, unintended outcomes, and path generation, have also received similarly limited attention. While certain observers (e.g. Rajan and Zingales, 2003; Roe, 2003; Gourevitch and Shinn, 2005) might explain cross-national diversity with particular reference to specified historical events, it is not yet clear what this might imply for reform-oriented research.

A purely path-based approach emphasizes the importance of historical context, evolutionary trajectory, and co-evolution of organizations and institutions. The relative merits of this approach can be summarized as follows. First, it is important to examine if/how certain SSG practices change through different life cycles of state owned enterprises (SOEs) (Filatotechev and Wright, 2005; Uhlaner et al., 2007). This lifecycle includes not only specific stages and sub-stages of development per se, such as start-up, expansion and maturity, but also transformation through different legal and organizational forms, including leadership succession, restructuring, initial public offering (IPO), and nationalization/renationalization. Filatotechev and Wright (2005) noted the varying salience of conflict and disruption across different life cycle related transitions. Second, while SSG practices are shaped by wider socio-economic intuitions, these institutions can undergo further transformations themselves (Lee and Mason, 2006). For example, where transitional economies have improved shareholder and creditor rights protection, related legal and administrative reforms have responded to wider socio-economic transformation rather than initiating and leading it (Pistor, 2006). The actual dynamics of such reforms, including public policy input and further legal implementation, need to be observed if different policy outcomes are to be understood (Fremond and Capaul, 2002). The issue of how SSG changes therefore requires fuller assessment of how it is shaped by both socio-economic transition and evolutionary trajectories (Delbridge and Edwards, 2007). Finally, the interaction of economic impetus and institutional determinants means that different causal processes and outcomes only unfold over substantial periods of time (Pierson, 2010, p. 13), implying that

SSG typically engages relatively slow-moving institutions (Roland, 2004). Given their possible redistributive effects, certain transformative changes attract opposition, and thus typically occur in an implicit and incremental manner. It can take time before reforms amount to anything substantial, with sizeable lags between their initiation and outcome. This is unlikely to be revealed by simply taking a ‘snapshot’ view of the current position alone, and inability to recognize cumulative and slow-moving reforms can lead researchers to “mistakenly construct temporally constricted causal accounts” (Pierson, p. 91).

Thus static theoretical linkages between observed governance practices and institutional environments or/and historical roots may not generate further insights into Chinese state sector reform. Further research should shift away from such static typologies towards studies of how particular systems and environments co-constitute each other (Morgan et al., 2006). Given that inadequate analysis of different institutional pathways limits the ability to understand the emergence of novelty (Storz et al., 2013), a path-based approach is necessary to explain what is most distinctive about Chinese SSG reform. At the outset of economic reform past central planning still imprinted itself upon most SOEs. Once legally and commercially restructured, leading SOEs left their former domestic confines, and later looked towards becoming increasingly global after the 2007-2009 Financial Crisis (Li and Milhaupt, 2013). Continuing problems such as party-state intervention and disparate objectives could be traced back to central planning but other issues, including managerial autonomy and investor protection, were duly linked with their changing socio-economic environment. According to Ho and Young (2013), various stages of SOEs reform came to reflect shifting official policies. While the neoclassical literature would typically emphasise the merits of market-based governance in advanced capitalist economies, China’s SSG system clearly diverges from both, and still exhibits unique institutional features (Wu, 2005; Nolan, 2007).

Moreover, gradualist reform implies that SSG practices may change dramatically “over extended periods of time but at a very low pace” (Pierson, 2010, p. 82). Its evolutionary trajectory contrasts strikingly with other radical political movements in Chinese history, such as the 1949 revolution and the end of the Cultural Revolution, where causes and outcomes were both temporally contiguous and rapidly unfolding. Such a slow-moving causal process can be termed as ‘incremental’ or ‘cumulative’ (Roland, 2004). Political scientists (e.g. Naughton, 1996; Pei, 2009) often conceive this strategy of “crossing the river by touching

the stones" as an evolutionary process with a stepwise endogenisation of the political constraints of economic reform. This cumulative process is often linked to the evolution of political and legal institutions, financial market development, the growth of non-state sector, and complementary reforms in other aspects of social life. Thus the evolutionary nature of Chinese state sector reform calls for in-depth understanding of the surrounding socio-economic context. It becomes apparent that a path-based approach can provide the means to assess the relationship and connections between governance patterns and environment over time (Delbridge and Edwards, 2007). For Bathgate et al. (2006), this approach helps overcome the biases inherent in transplanting developed-economy "prisms" to a different environment where they appear less suited.

When embracing a path-based approach, researcher often hold two distinctive views of institutional change i.e. path dependence versus path generation, which itself leads to different appreciations of SSG evolution. Earlier work on institutional evolution was based on a path-dependence model that also relied upon 'external shocks' and 'punctuated equilibrium' (Delbridge and Edwards, 2007; Pierson, 2010, p. 134). With its emphasis on self-reinforcing mechanisms, this argued that previous institutional settings strongly impacted upon later development, as if to preclude major deviations or innovations. In this view, only exogenous shocks provide succinct phases and episodes where real opportunities for major institutional reform occur, even if these are followed by protracted stability. However, given an emphasis on institutional reproduction, this model makes it difficult to account for incremental but potentially transformative changes (Thelen, 1999, 2004). Pierson (2010, p. 153) notes that "institutions will generally be far from plastic, and that when institutions have been in place for a long time, most changes will be incremental". Recent institutional research sees institutionalization in more dynamic, social process terms (e.g. Garud and Karnøe, 2001; Garud et al., 2010). The path generation literature sees important roles for particular social actors, considered as reflexive and proactive agents for initiating and implementing transformations. As this work develops, one key challenge is to find ways to capture alternative transformation paths, with respect to their complex inter-relationship with both the surrounding socio-economic context, and also specified social actors. However, to understand change, or the relative lack of change, it is important first to conceptualize how path dependence might operate (Thelen, 1999, 2004; see also Peters, 2005, p. 77).

3.3 Institutional Continuity in SSG

Emerging cross-national comparisons can reveal certain unique features of national SSG institutions while testing the assumptions derived from only one single country. Empirical evidence suggests that national SSG systems retain certain unique features and even comparative advantages in the face of globalization. Such striking and persistent variances reveal the deficits of efficiency-based arguments and the very institutional stability or continuity that inhibits further reform.

3.3.1 A Path Dependence Perspective

Path dependence theory has emerged to explain protracted institutional stability and continuity. Research in this genre is often viewed as part of a broader debate over convergence-or-divergence between different governance regimes (Bebchuk and Roe, 1999; Schmidt and Spindler, 2002; Yoshikawa and Rasheed, 2009). Comparative research on state or public sector reforms raises two important questions for both researchers and policy makers: (1) what causes any variance in the national governance systems to persist, and (2) can and will such institutional variances continue in future (Bebchuk and Roe, 1999).

In economic history, path dependence has been used to explain so-called “lock-in” tendencies. Mahoney (2000) observed that the original conceptualization of path dependence by historical sociologists had certain defining features. First, path dependency was highly sensitive to events taking place in the early stages within an identified causal process, so that these events mattered more than others occurring later (Pierson, 2000). Second, these earlier events were contingent occurrences which could not be fully explained by prior historical conditions alone. Goldstone (1998, p. 834) noted that “path dependence is a property of a system such that the outcome over a period of time is not determined by any particular set of initial conditions. Rather, a system exhibits path dependency is one in which outcomes are related stochastically to initial conditions”. Third, once contingent events occur, path dependent sequences become relatively deterministic, tending towards what Mahoney termed “inertia”. This inertia may vary according to identifiable sequences: in self-reinforcing sequences, it refers to stabilization mechanisms that perpetuate specified institutional arrangements; conversely, with reactive sequences, inertia involves counter-reaction mechanisms or backlash forces that give events a logic where one event inevitably leads to another.

A common thread among definitions of path dependence is an assumption that “past events influence future events” (Mahoney, 2000, p. 510). However, path dependence theorists go beyond simply holding that “the past influences the future”. For example, Mahoney suggested that a path-dependent sequence should consist of contingent starting points and critical junctures as well as any subsequent self-reinforcing mechanisms which make initial institutional arrangements hard to refute.

“Institutions that rapidly and decisively trigger mechanisms of reproduction are especially capable of seizing opportunities by contingent events and thus setting into motion self-reinforcing sequences that are path-dependent. Efficacious mechanisms of reproduction enable an institution to take advantage quickly of contingent events that work in its favour, solidifying a position of dominance before alternative institutional options can recover. By contrast, with institutions that more gradually trigger mechanisms of reproduction, a contingent event may initially favour the institutions, but the institutions will not prevail in the long run over superior alternatives because mechanisms of reproduction are activated quickly enough or powerfully enough to capitalize on the early advantage”(Mahoney, 2000, p. 515).

When examining salient differences in national SSG systems, comparative researchers often regard governance institutions as analogous to manufacturing technology, and treat observed institutional variations as having specific competitive consequences. Under globalization, the quest for competitiveness and cross-national capital inflows would potentially eliminate more inefficient governance practice, and compel further improvements (Khanna et al., 2006) which would minimize, if not eliminate, undue rent-seeking and inefficiency. However, as well as efficiency, SSG necessarily embraces political institutions and developmental goals (Leftwich, 1995; Walder, 1995; Pierre, 2000; Lichet et al, 2005), and SSG regime diversity persists (Vagliasindi, 2008; Chung and Zhang, 2011). In addition to socio-political factors, emerging research seeks more dynamic explanations about how distinctive national SSG system emerge, and observes how earlier institutional settings and policy preferences influence subsequent institutional movements and policy shifts.

Stark (1994) compared privatization strategies and policy outcomes of transitional economies using a path dependence framework that delimited those elements inherited from their socialist past, and found a significant source of the observed variances arose through identifiable socio-political imperatives (see also Nee and Cao, 1999). For Stark, the choice

between statist versus market strategies for dismantling the state sector was highly dependent on the path of extrication from state socialism, and the preceding differences in social structure and political organization in the given country. The latter meant that interest group politics, in particular mediation between state and civil society, differed significantly. Thus, in Czechoslovakia, a state interventionist past counterbalanced liberal-market reforms; the Polish tradition of workers' self-management likewise restrained privatization efforts (see Kovács, 1994). Nee and Cao (1999) emphasized the deterministic effect of the initial structure of property rights and governance system upon mixed ownership arrangements across different regions of China. These pre-existing patron-client ties linking state bureaucrats with other societal actors continue as highly fungible forms of political and social capital. For Nee and Cao (p.803), "economic liberalization releases the old communist elite from pre-existing organizational controls, enabling them to pursue rents in boundary transactions between the public and market sectors of the transition economies". Bebhuk and Roe (1999) referred to this type of path dependency as "structure-driven" in that it encourages structural rent-seeking by beneficiaries. It explains how the private advantages of initial property rights arrangements present significant barriers against ownership transformation. In Chinese SOE reform, state bureaucrats may sacrifice private benefits only if they can be immediately and adequately compensated by any resulting transformation. They have both incentives and power to impede efficiency-seeking changes that reduce their interests. The relative political strength of entrenched interest groups can affect any legislative process that combines public-regarding features with interest group politics. For Roe and Bebhuk (p. 131), initial governance structure and property rights affording control to a particular group of stakeholders will "increase the likelihood that the country would subsequently have the rules favoured by this group of players" (Martin, 2006).

3.3.2 Explaining Self-Reinforcing Institutional Stability

Recent path dependence thought conceives institutional stability as a dynamic process where self-reinforcing mechanisms entrench and reproduce institutional frameworks through time (Djelic and Quack, 2007; Hall and Thelen, 2009; Martin, 2006, 2010).² Using Mahoney's (2000) categorization, the prevailing paradigms which explain institutional reproduction are classified as utilitarian, functional, power and legitimation-based as follows.

² Long before the introduction of a path dependence analysis, economists, sociologists, political scientists, and historians have made various contributions to account for the underlying mechanisms leading to the institutional stability (Ebbinghaus, 2005).

3.3.2.1 Utilitarian Factors

As the most frequently cited causes of continued institutional reproduction, these refer to a non-linear self-reinforcing process with strong rationalistic underpinnings (Arthur, 1989; North, 1990; David, 1994; Ebbinghaus, 2005; Djelic and Quack, 2007). This stems from the economic history literature regarding the lock-in tendency explained before. From this perspective, social actors “rationally” opt to maintain previous institutional arrangements where potential benefits outweigh the costs of transformation. North and Mahoney both identified a number of factors which perpetuate any given path: for example, large set-up or sunk costs, learning effects, coordination effects, and adaptive expectations. First, set-up costs lead to prolonged institutional stabilization where such investment provides actors with incentives to maintain initial structures in order to recover costs (Schmidt and Gerald, 2002; Deeg and Jackson, 2007). Second, beliefs that repeated institutional arrangements enable greater efficiency gains may themselves generate continuity, always assuming that actors become more adept and knowledgeable about prevailing arrangements. Third, coordination impacts upon maintenance of existing institutional arrangements where expanded usage of particular practices creates higher returns still. These effects are especially significant when institutions require high network externality.³ Finally, institutional continuity arises from self-fulfilling expectations in situations where incoming social actors are required to adopt and support institutions by those already conforming to them. As Deeg (2005) noted, the assumption underlying all such utilitarian explanations is that actors will choose to reproduce particular institutions through self-interest above all.

While economists take this approach to explain issues such as the spatial location of production (e.g. Arthur, 1994) and expanded intra-industry trade in the post-WWII era (e.g. Krugman, 1996), North’s (1999) approach to emergent institutional change provided fresh explanations for related “stickiness” (Nee and Cao, 1999; Pierson, 2000). According to North, the approaches by which economic historians study technological returns were also applicable to institutional reproduction. Due to increasing returns, earlier contingent institutional arrangements, once adopted, can deliver increasing benefits through their repeated adoption. This makes it difficult to transform institutions or revert to previously available options despite any potential efficiency gains. Where switching costs exceed

³ For example, if other firms within a same economy are featured by a diffuse ownership structure, it will be less costly and more efficient for a firm to choose such a structure (Bebchuk and Roe, 1999).

potential gains, actors might rationally retain seemingly inferior institutional arrangements (Schmidt and Gerald, 2002; Gordon and Roe, 2004, p. 15). In this way, “established institutions generate powerful inducements that reinforce their stability and further development” (Pierson, p. 255). Bebachuk and Roe (1999) argued that, comparing a seemingly inefficient system with its counterpart, they could each have merits and flaws. Given that transforming one institutional structure into another involves added economic and social costs, even maintaining the status quo has its attractions, though high switching costs also foster institutional entrenchment (Schmidt and Gerald, 2002).

3.3.2.2 Functional Factors

Here Mahoney (2000, p. 519) interpreted self-reinforcing path dependence thus:

“the institution serves some function for the (overall) system, which causes the expansion of the institution, which enhances the institution’s ability to perform the useful function, which leads to further institutional expansion and eventually institutional consolidation. Thus system functionality replaces the idea of efficiency in utilitarian accounts as the mechanism of institutional reproduction”.

In this view, institutional elements are reproduced because each serves a particular function in an overall system where complementarity dominates. According to Schmidt and Gerald (2002, p. 319), elements are only regarded as complementary if there is potential “fit”, i.e. “take on values which mutually increase their respective benefit in terms of whatever the objective function or standard for evaluating the system may be, or mutually reduce their disadvantages or costs”. In this respect, factors enabling particular SSG systems (such as political institutions, legal and regulatory framework, administrative apparatus, corporate codes, and financial markets,) can all be regarded as complementary elements.

For example, in the context of a market-based governance model, the role of competitive conditions for optimal resource allocation becomes central, making ownership diversification secondary (see Lin et al., 1998; Li et al., 2000). This requires active involvement of the private sector, regulatory efficiency and accountability, due corporate governance (CG) mechanisms, effective state-asset management, and well-developed financial sectors. Further complementary elements may include tradition and respect for private ownership, autonomous regulation and supervision, as well as effective policy

enforcement (Estrin, 1998; Perotti, 2004; OECD, 2005, 2011). The market-based governance model is thus a consistent configuration of specified complementary mechanisms which together constitute a distinctive SSG system in its own right.

Given complementarity among different institutional elements, and also the advantages of consistency, partial changes to any individual element alone will not necessarily bring full systemic improvement. This has implications for the top-down transferability of reform strategies or governance practices from advanced emerging markets (e.g. Redding, 2004), and even between developed economies themselves (Berglöf and Thadden, 1999). Where such complementary institutions are inadequate, reforms are likely to be impeded. Given the necessary complementarity of those elements which comprise individual SSG systems, it would not necessarily make sense to import different individual elements from outside, especially where deeper differences about transplantation still prevail (Fleischer, 2005).

For Lichet et al. (2005, 2007) undue emphasis on embeddedness and hierarchy among developing and transitional economies can be conducive to corruption and disregard of judicial independence. Thus the challenge for reform designers would be to “find mechanisms for encouraging pro-social conduct among state regulators and other power holders” (2005, p. 252) rather than to improve court legislation. Pareded (2003, 2005) suggested that the question of the “macro-fit” between transplanted governance practices and broader socio-cultural backgrounds of the “importing” country requires further research. To be effective transplantation of governance mechanisms relies upon their being suitably adapted to the pre-existing economic and social characters of the “importing” body. In this view, simply importing Anglo-American corporate codes, or another market-based model, is not necessarily viable for developing countries, especially where that model presupposes well-developed equity markets and legal infrastructures. In the case of CG reform, complementarity and consistency between different institutional elements suggests that “it would probably not make much sense to mix the outsider and insider control system and to combine those elements that appear to be particularly valuable in each of the two types of systems so as to create the overall optimum” (Schmidt and Gerald, 2002, p. 324).

3.3.2.3 Power and Legitimation

This argues that actors' differential resource endowments generate divergent interests vis-à-vis institutional continuity given the likely redistributive effects of change. Mahoney (2000,

p. 114) suggested that “an institution can persist even when most individuals or groups prefer to change it, provided that the elite that benefits from the existing arrangement has sufficient strength to promote its reproduction”. The dynamics of power entrenchment are summarized thus:

“Once the institution develops, however, it is reinforced through predictable power dynamics: the institution initially empowers a certain group at the expense of other groups; the advantaged group (thus) uses its additional power to expand the institution further; the expansion of the institution increases the power of the advantaged group; and the advantaged group encourages additional institutional expansion. Because early events are contingent, this sequence of empowerment can take place even though the group that benefits from the (later introduced) institution was initially subordinate to an alternative group that favoured the adoption of a different institution”.

Nee and Cao (1999) observed that, even during dramatic social transformation, entrenched interests from previous institutional arrangements could still have incentives to maintain their former status quo. The inertia faced by reformers is not only interest-based but also locked into interrelated institutional arrangements (DiMaggio and Powell, 1983). This power-based approach can explain how pre-existing SSG institutions continue across transitional economies in Eastern Europe. For Nee and Cao, the party-state, as the axial institution of centrally planned economies, governs by fiat power and exerts direct political control over social institutions. The institutions of state ownership and extensive administrative networks linking various government departments and party bureaucracies induce continuing political-power dependence. The ability of actors to mobilize power resources firstly depends upon the particular institutional structure inherited from past central planning and, given state control over productive resources, early market transition can provide previous elites with opportunities for political-economic capital conversion to maintain their elite standing (Pierson 1993; Ebbinghaus, 2005; Martin, 2010).

Parallel with power-based explanation, legitimacy-seeking emphasizes institutional continuity and entrenchment. Legitimacy-seeking accounts of institutional reproduction maintain that decisions which perpetuate pre-existing institutions are grounded in the actors’ subjective orientations and beliefs about what is most legitimate, appropriate or morally correct (Dowling and Pfeffer, 1975). The logic of “appropriateness” and the alignment of normative and cognitive institutional models therefore underlie the quest for legitimacy

(March and Olsen, 1998; Djelic and Quack, 2007). Mahoney (2000, p. 523) further elaborated that:

“Institutional reproduction occurs because actors view an institution as legitimate and thus voluntarily opt for its reproduction. Beliefs in legitimacy of an institution may range from active moral approval to passive acquiescence in the face of status quo. Whatever the degree of support, however, legitimation explanations assume the decision of actors to reproduce an institution derives (mainly) from their self-understanding about what is right to do, rather than from utilitarian rationality, system functionality, or elite power”.

A contingently introduced institution can be stably perpetuated through increasing legitimation even where alternative institutions might have differed. This is marked by a positive feedback loop in which a preceding institutional arrangement forms the basis for future normative evaluation. Under the logic of “appropriateness” contingent institutions are perpetuated and maintained by legitimacy-seeking social actors. Institutional initiatives are less likely to become stabilized if their legitimacy and constituencies remain limited. Greener (2005) argued that the feedback generated through their reproduction can preclude the emergence of different and competing understandings of institutional change and vested interests. Organizations adopt “institutional isomorphism” by replicating institutions not only for potential efficiency improvement but also for their acknowledged legitimacy and appropriateness, especially when “conditions of uncertainty typically reinforce old networks and patterns as people turn towards the familiar and the safe” (Johnson, 2001, p. 254). Institutional legacies thus shape the opportunity structure and strategic preference of social actors, but limit the range of normative repertoires invoked for institutional responses (Hausner et al., 1995; Streeck and Thelen, 2009). A sociological perspective would focus upon institutionalization with reinforcement: norms become further internalized when ruling cognitive schemata and taken-for-granted routines are relatively unchallenged (Zucker 1977; Ebbinghaus, 2005).⁴

3.3.3 The Limits of Institutional Continuity

Path dependence theory emphasizes how initial conditions further impact upon subsequent

⁴ Deriving from the legitimacy argument, socialization is referred by Djelic and Quack (2007) as a complementary binding force that can reinforce and stabilize the emerging path-dependency. Under the socialization argument, institutional stabilization is essentially a process of social learning (see Hermann-Pillath, 2009).

developments. However, the concept of institutional stability is criticized for being over-static and neglecting the drivers of change (Thelen, 2009). Debates about its applicability spread across different disciplines, especially institutional and organizational studies (e.g., Pierson, 2000; Crouch and Farrell, 2004; Greener, 2005). The particular problem for researching China's SSG reform however concerns the "fixity" and "rigidification" of institutional evolution (Martin and Sunley, 2006).

Where characterized as "punctuated equilibrium" (Peters et al., 2005), institutional change is "a periodic and episodic process, wherein major (external) shocks cause system-wrenching change that then establishes a new phase of relative stability" (Martin and Sunley, p. 407). Path destruction and creation appear relatively serendipitous and exogenously induced. The ahistorical institutionalism of path dependence views institutional changes in a bifurcated manner, as either long-drawn institutional reproduction, or else radical and disruptive reorientation. The question thus arises where, if a defining characteristics of institutional evolution is "endogenously granted change" (Martin and Simmie, 2008, p. 188), does the punctuated equilibrium model capture the full variety of change? The descriptive account of path dependence emphasizes self-reinforcing processes but remains silent about "how and where institutional novelty comes from, or why one form of novelty gets selected over another" (Martin and Sunley, p. 407). Moreover, path dependence theory is criticized for adopting an "outsider" ontology that neglects the reflexive social actors involved. The paradigm asserts that "the past intrudes into the present and as a constraining force, contingencies that arise are experienced as unanticipated unprepared moment, and the future present itself as a fundamentally uncertain terrain" (Garud et al., 2010. p. 768; see also Streeck and Thelen, 2009).

In sum, path dependence is not necessarily either the only or best source for explaining change in/of institutions (Peters, 2005, p. 79). The notion of institutional stability or continuity can exaggerate how institutions evolve a "lock-in" that impedes further change, and can underestimate the possibilities of significant deviation and innovation. For Crouch and Farrell (2004, p. 5), this argument is in "danger of becoming excessively determinist and incapable of coping with major (institutional) innovations except as behaviours derived from imitation or completely exogenous learning". To compensate, institutional theorists should focus on the endogenous attributes most conducive to path-deviation including how social actors "seek to adapt to changed environmental circumstances through changing their

institutional responses to that environment" (Crouch and Farrell, 2004, p. 6; see also Garud et al., 2010). Methodologically, researchers should investigate changes in "real time" and "follow the actors" to find out how they occur (Callon, 1986; Streeck and Thelen, 2009; Garud et al., 2010).

3.4 Path Generation

Although path dependence would explain how settled technological patterns generate self-reinforcing mechanisms in order to continue, institutional transformation differs in several ways (Pierson, 2000). To further develop related theory and account for institutional evolution, this section asks: (1) what are the primary sources or mechanisms for institutional transformation, and (2) why should we apply path generation perspective to further studies of national SSG systems?

3.4.1 Sources of Path Generation

Dacin et al. (2002) argued for the importance of deinstitutionalization where extant institutions are deteriorating or/and being delegitimized while other innovative practices are emerging. Campbell and Pederson (2006) point out that "revolutionary change" among post-socialist countries often embodies significant "evolutionary" qualities as well. Both Stark (1992) and Johnson (2002) emphasized the time dimension of institutional change and the importance of its sequencing in different stages. The available literature emphasizes the following major sources and mechanisms for inducing institutional changes and innovations: (1) functional pressure, (2) political pressure, (3) structural factors, including institutional embeddedness and openness.

3.4.1.1 Functional Pressure

According to Dacin et al. (2002), functional pressure for deinstitutionalization often arises in response to performance issues in regard to practices whose efficiency falls into question. DiMaggio (1988) and Zucker (1988) previously argued that deviation from an enduring practice is likely to occur as a result of changed technical instrumentality, rather than interest redistribution, although this practice may still have some worth.

For Oliver (1992), the potential for performance problems to further deinstitutionalize enduring practices itself derived from competitive and functional considerations that

question their continuing instrumental value. Institutional deviation often occurs within a changing socio-economic environment in which heightened competition for scarce resources makes certain activities less advisable. The competitive logic underlying path-deviation means that “new organizations with more efficient structures will develop, and eventually replacing suboptimal organizations” (Pierson, 2000, p. 487). For example, at national level, Ananchotikul and Eichengreen (2009) highlight significant improvement in the quality of Asian CG practices and regulatory enforcement driven by the quest for financial stability and sustainable economic growth following the Asian Financial Crisis. At firm level, Lee and Penning (2002) found performance differentials among competing businesses served as an important source of feedback which further deinstitutionalized inefficient accounting practices.

3.4.1.2 Political Pressure

Established institutions and practices face erosion or replacement where their legitimacy becomes seriously questioned. Oliver categorized the political conditions where ‘delegitimation’ or ‘deinstitutionalization’ can be predicted as: (1) deteriorating performance of extant institutions, (2) contention between emergent social actors and the status quo, (3) mounting pressure for institutional innovation and re-adjustment, and (4) reduced reliance upon institutional constituents requiring continued stringent conformity. In this view, to deviate from the entrenched institutions is either a defence against threatened failure or political response to power shifts between established and emergent social actors. Thus institutional innovation occurs through political efforts to revolve tension arising from the reduced validity or legitimacy of entrenched norms and practices such that survival needs to be assured.

The first two mechanisms primarily concern the intra-institutional factors behind internal political dissensus or disputed norms and practices. Performance problems that threaten institutional legitimacy or viability question the validity of accepted norms and practices. Oliver (1992) noted that performance crisis can accentuate conflict and contention about appropriate institutional arrangements. Conformity with institutionalized practices also rests upon dependence upon specific environmental constituencies (DiMaggio and Powell, 1983) and its necessity may erode if that dependency diminishes as alternative constituents or/and ‘institutional entrepreneurs’ emerge (Streeck and Thelen, 2009).

3.4.1.3 Structural Factors: Embeddedness

Complexity increases as the focus shifts towards national institutional systems which also interact with each other transnationally (Djelic and Sahlin-Andersson, 2006; Scott, 2001). Thus, the coupling of complementary subsystems may vary, as can the intensity of interactions among different national systems, suggesting multiple pressure points subjecting national institutions to change.

Embeddedness or nestedness refers to co-existent institutions enhancing each other, i.e., institutional complementarity. Beyond perpetuating equilibrium, institutional complementarity can promote systematic transformation should interdependence wane. For Ebbinghaus (2005, p. 23) “while the interlocking between institutions may loosen, an institution may be also endangered through tight coupling with another institution if this complementary institution can no longer provide or else has changed its function”. This draws attention to the limited life span of specific institutional configurations and poses questions about off-path change. Deeg (2005) thus claimed that more tightly coupled institutional systems were more liable to change than others. For example, the insider character of Korean state-owned *chaebols* requires more congruent business strategies and linkages than so-called “parchment institutions” (see Kim, 1997). Thus, looser coupling among subsystems may not necessarily mean weaker path dependency, since these constituent systems may derive their stability from different sources. However, “institutional hierarchy” among complementary institutions suggests that, if the initial change occurs in the hierarchically “dominant” institutions and domains, the cascading effect of deinstitutionalization could precipitate systematic transformation (Hall and Soskice, 2001; Boyer, 2006; Amable, 2009). Contrariwise, changes in “subordinate” subsystems exert less influence upon dominant or complementary institutions.

3.4.1.4 Structural Factors: Openness

Openness challenges conventional assumptions about the existence of sovereign, authoritative and autonomous national institutions presiding over their own territories. With regards to transitional economies, Sun and Tobin (2005) documented how international listing of Chinese SOEs provoked meaningful improvement in governance practices despite opposition from powerful entrenched interests. By opting into foreign stock exchanges with higher standards of CG, listed SOEs are mandated to improve investor protection in fear of

potential (state) asset depreciation (see Jia et al., 2005; Coffee, 2006). Surveys by OECD (2005b, 2011) indicate that both stock listing and market deregulation have induced further SSG reform across many advanced economies, including Germany, France, Britain, Switzerland, and Finland. Along with a long-term fiscal squeeze this means that the state sectors of these countries have been relatively open to competitive pressure and investor influence. In addition to a shrinking portfolio of SOEs, many governments have revised their ownership functions and enhanced investor protection in order to attract greater capital inflow.⁵ Change has been concentrated mainly in the areas of “the state acting as an owner”, “transparency and accountability” and “the functioning of SOE boards”, paving the way towards a more coordinated SSG model (OECD, 2011, p7). In reviewing the legal and regulatory development of developing countries, OECD also highlights the importance of international standard-setting organizations for generating new paths. Evidence suggested that the increasing interaction and ideological homogenization of different standard-setting organizations helped generate and stabilize “an emerging transnational path of rule-setting” (Djelic and Quack, 2007, p. 181). In this case, local regulatory bodies often acted as “transmitters and mediators” to implement such international rule setting. An off-path change can thus arise through a pincer movement where “external pressure or solutions are connected with local stakeholders and their traditions” (Djelic and Quack, 2007, p. 181).

3.4.2 Path-Generation Dynamics

There is much emphasis on sources for incremental changes which are, at most, cumulatively transformative. However, sources for path generation, whether functional, political, or structural, will not automatically lead to the breakdown of entrenched institutions. An explicit theoretical framework is still needed to account for how institutional transformation occurs, i.e. how new and existing institutional arrangements interact so that other “innovative” structures and processes might emerge (Dacin et al., 2002). Discussion of institutional transformation is often linked to different claims about the relative merits of “agents” versus “structures” which now merit further consideration.

The literature on “post-socialist countries” and “varieties of capitalism” would account for how institutional innovation occurs despite structural inertia and rigidity. The former is particularly relevant to Chinese state sector reform since it typically highlights institutional

⁵ OECD (2011) observes that, with regards to empowering minority shareholders, significantly lowered ownership thresholds encouraged more German and Spanish investor litigation.

innovation through recombinant strategies in the face of powerful legacies from the command economy before. Streeck and Thelen (2005) discuss four different modes of change (i.e., displacement, conversion, layering, and drift) to grasp the evolutionary nature of institutional transformation (see also Thelen, 2009; Mahoney and Thelen, 2010). This section traces certain potential theoretical antecedents for each mode of change, and discusses what this implies for the study of Chinese SSG reform.

3.4.2.1 Displacement

Streeck and Thelen (2005, p. 18) denoted displacement as the process in which “new models emerge and diffuse, which call into question existing, previously taken-for-granted organizational forms and practices”. When “displacement” first appeared, it was barely elaborated and only drew limited attention, because it was considered “rare in the politics of reform in contemporary advanced capitalist economies” (Thelen, 2009, pp. 488; see also Heijden, 2010). However, research into economic reform in both transitional and advanced economies provides further evidence about the plausibility of effective institutional transformation through displacement. For these purposes, what is interesting about displacement is how institutional transformation can occur, not only through explicit readjustments and amendments among existing institutions, but through shifts in the relative salience of competing institutional arrangements (Streeck and Thelen, pp. 18-22).

Crouch and Keune (2005) illustrated how displacement worked during the attempted liberalization of Hungary’s state-socialist economy, which for political reasons retained links with the previously dominant centrally-planned model. Even under Communist dictatorship, local political and economic actors in the Győr region enacted reforms intended to improve enterprise productivity and living standards. These included gradual decentralization of decision-making power to enterprise managers, legalization of private business activities, and policies to attract FDI. With the decline of state socialism, local elites advocated quick transition towards a market economy, and Győr here proved more adaptable because certain pre-1989 practices provided the necessary foundation. Campbell and Pederson (1996) observed similar reform elsewhere where market-oriented practices were attempted before being submerged under renewed state socialism. They used the concept of “institutional bricolage” to describe post-socialist transition across Eastern Europe where new institutions were selectively incorporated into pre-existing institutional settings through reform efforts. Such reform strategies commonly represent “the deliberate bricolage of rhetoric based on

principles of both market and communist economic discourses” (Campbell and Pederson, p. 213). One common element concerned how various market-oriented policies first developed when leading local actors articulated notions of “market socialism” or “socialism market economy” in successive steps. In this respect, institutional change through displacement needs to be carefully cultivated by those key actors whose interests are better safeguarded and served by new arrangements.

3.4.2.2 Conversion

Tsai (2006) examined the emergence of China’s private sector through what Thelen (2004) termed “institutional conversion” requiring the redeployment of extant institutions for alternative purposes. This argues that, even though the formal attributes of previous institutions remain, their substantive orientation or purposes can change dramatically. For Beland (2007, p. 22), “(institutional) conversion is about adopting new goals or bringing in new actors that alter the institutional role or the core objectives of an institution”. The Chinese strategy of “wearing a red hat” can be viewed in this light. For Tsai this refers to registering a business as a collective enterprise which is nonetheless essentially privately owned and managed. Moreover, by paying an SOE for use of its name, private entrepreneurs disguise their own company as an appendage to an established government operation in order to avoid being socially and politically marginalized.⁶ Tsai (2006, p. 129) elaborates how this ‘red hat’ practice enabled private sector development in the face of both legal restrictions and ideological constraints.

“On a day-to-day basis, entrepreneurs were also subject to arbitrary treatment by tax collector and harassment by other bureaucrats. By contrast, state and collective enterprises received favourable treatment relative to private ones in terms of tax breaks, bank loans, and use of land...As a result, hundreds of thousands of both state and non-state actors were complicit in popularizing the red hat phenomenon...Although conservative or “leftist” political elites would have preferred to restrict the non-state sector, both the popularity and economic effectiveness of wearing a red hat gave reformers concrete evidence and, thus, political support for expanding the scope of China’s nascent private economy...Camouflaging the true ownership structure of a (private) business rendered the formal distinction in nomenclature between collective and private enterprises virtually

⁶ Such enterprises were termed as hang-on enterprises (*guahu qiye* in Chinese) during the first decade of China’s economic reform (Tsai, 2006).

meaningless” (Tsai, 2006, p. 129).

By 1987, when private business obtained politically ceded legal approval,⁷ 225,000 private enterprises employed over 3.6 million and average firm employment over 16 exceeded that permitted before.

3.4.2.3 Layering

Layering refers to “a process in which one institution is introduced either alongside or on top of existing arrangements” (Wentzel, 2011, p. 50). Thus by “grafting” new elements onto the pre-existing institutional framework, a series of small amendments may ultimately, and probably cumulatively, contribute to overarching reform (Thelen, 2004, p. 35; Wentzel, p. 50). According to Wentzel, two important issues underpin this process, one the intensity of how different reform efforts are layered, the other the incentives for social actors to pursue change.

The legislative reform of Germany’s capital market is one example. Deeg (2001) and Thelen (2012) illustrated how the strategic transformation of universal banks prompted regulatory bodies to accelerate change. Facing reduced corporate borrowing and potential profit from investment and fee-based services, German banks gradually switched from cheap credit provision towards a US investment banking model based more upon well-developed security markets.⁸ They formed a pro-reform coalition with the relevant regulatory bodies and then sought to promote stock market development. These included the establishment of “Frankfurt Coalition” in 1984, amended Stock Exchange Law in 1989, the introduction of IBIS electronic trading system and the first of three Financial Market Promotion Laws in the late 1989. While 1980’s reforms emphasized lower trading cost and financial innovation, further reforms “extended and expanded upon prior efforts” (Deeg, 2001, p. 26). Without radically displacing the traditional regulatory system, reform clearly impacted upon financial market development when both the regulatory efficacy of stock exchanges and transparency of listed companies were significantly improved. Deeg observed that “all these omnibus laws contained numerous and wide ranging statutory additions and amendments intended to

⁷ At the 13th National Congress of the CCP in October 1987, former Premier Zhao Ziyang declared that “cooperative, individual and private sectors of the economy in both urban and rural areas should all be encouraged to expand... [W]e must formulate policies and enact laws governing the private sector as soon as possible in order to protect its legitimate interests” (Beijing Review, November 9-15 1987, cited in Tsai, 2006).

⁸ Historically, relationship between large industrial corporations and commercial banks were largely long-term lending-based so that banks could grow and profit primarily from the close associations (Deeg, 2001).

stimulate the supply and demand of securities” (p. 25).⁹ Consequently, governance practices in many “insider-controlled” firms, in particular those owned by the federal government, became more shareholder-oriented, while the banks' traditional monitoring role was taken over by the security market.¹⁰ Therefore, by “patching-up” old institutions through establishing and expanding the regulatory basis for a well-functioned financial market, these innovative “layers” enabled further security market development while offering a more acceptable rationale for German banking reform.

3.4.2.4 Drift

Drift is not always how social actors intended to change existing institutions, “if it is about institutional change at all in the truest sense of the concept” (Wentzel, p. 51). It essentially refers to the environmental changes that transform the initial purpose of an institutional arrangement, as well as the inability of institutions to readjust to these changes. With conversion, institutional transformation through drift, while potentially consequential, may be masked by superficial stability. However, behind their seemingly static appearance, institutions still require active maintenance.

“To remain what they are they need to be reset and refocused, or sometimes more fundamentally recalibrated and renegotiated, in response to the changes in the political and economic environment in which they are embedded. Without such ‘tending’...they can be subject to erosion or atrophy through drift...In cases like this, drifts occur without explicit political manoeuvring: the world surrounding an institution evolves in ways that alter its scope, meaning, and function” (Streeck and Thelen, 2005. pp. 120-121).

An example of institutional drift occurred in the once centralized German wage setting system which originally implemented industry-wide agreements through works councils with quasi-statutory status. These councils consisted mainly of elected workplace representatives and even extended into the small-firms sector.¹¹ As collective bargaining

⁹ The departure of the German banks from their conventional business strategy and the growth of the financial market increased the demand on listed firms' investment return and on their endowment with capital (Streeck and Thelen, 2005, p. 85).

¹⁰ Historically, Germany's insider-controlled model was based on extensive business network and concentrated ownership structure, which encouraged “a stakeholder management approach to the management of German corporations” (Deeg, 2001).

¹¹ In a large economy like Germany, the egalitarianism of collective bargaining system had been able to generate and maintain low wage dispersion until the late 1980s when the coverage of such a highly centralized system began to experience a cross-sectoral shrinkage.

agreements declined, this system drifted, and veto players neither sought nor were able to block further institutional innovations, including so-called “opening clauses” (Massa-Wirth and Seifert, 2004; Martin, 2006, 2010). Certain bargaining rights were essentially transferred to formally non-union works councils legally prohibited from detailed wage negotiating and setting. Such institutional flexibility gave individual actors more discretion over the choice and enforcement of alternatives, so that for Streeck and Thelen (p. 93) “the traditional bargaining regime ceased to be encompassing and turned into the shrinking and softening core of a new, much less unified, and much more diverse system”.

3.4.3 Role of Social Actors

For Seo and Greed (2002), institutional contradictions do not necessarily lead to path-breaking transformations. Between institutional contradictions and change comes mediating human praxis where actors consciously acknowledge the need to overcome entrenched institutional resistance. In this view, path generation also refers to the proactive and conscious response by actors to evolving internal and external environments (Oliver, 1992). For Streeck and Thelen (2005, p. 19),

“Such changes often occur through the rediscovery or activation and, always, the cultivation of alternative institutional forms. As a growing number of actors defect to a new system, previously deviant, aberrant, anachronistic or foreign practices gain salience at the expense of traditional institutional forms and behaviours”.

In other words, social actors are less passive receivers and more proactive makers of institutions when they infuse their actions with other meanings to reflect this (Dacin, Goodstein, and Scott, 2002; Zilber, 2002). Moreover, an emergent path implies that different actors together shape institutions (Morgan and Kubo, 2005; Morgan and Quack, 2005).

Eisenstadt (1980, p. 14) introduced the idea of institutional entrepreneur for proactive actors proposing innovative policies and practices which provide “the opportunity to realize interests that they value highly”. However, efforts at imposing new institutions may not go uncontested. In path generation, institutional entrepreneurs face resistance and opposition from entrenched interest groups whose privileges are tied into prevailing institutional arrangements (Levy and Scully, 2007). Such social actors as institutional entrepreneurs operate in an institutional field subject to “the regulative, normative, and cognitive processes

that structure their cognitions, define their interests, and produce their identities” (Clemens and Cook, 1999, p. 9). Such an embeddedness based view implies that institutional entrepreneurs possess can both imagine alternative possibilities and exploit social resources depending on the particular institutional projects they pursue. This involves both criticizing existing institutions and mobilizing other allies so institutional inhabitants can break the dominant ethos.¹²

Certain researchers (e.g., Philips et al., 2004; Leca et al., 2008) suggest that institutional entrepreneurs commonly adopt a discursive strategy to promote institutions and practices that will resonate with potential allies. To initiate discursive transformation, entrepreneurs firstly specify existing organizational defects, and then assign blame and responsibility for such, thereby questioning the legitimacy of dominant practices. After asserting the superiority of their alternatives, they consolidate and expand their allies so that pre-existing institutional arrangements become de-legitimized. Their success can also depend upon their access to those scarce and critical resources judged indispensable to mount further political action (Lawrence et al., 2005). These resources may include finance (e.g. Leca et al., 2008), social capital (e.g. Fligstein, 1997), formal authority (e.g. Maguire et al., 2004), and previous earned legitimacy (Greenwood et al., 2002). Leca et al. (2008) suggest that the question of which resources are more useful is largely dependent on context. Such an understanding of path generation resembles how Garud and Karnøe’s concept of path creation highlighted the role of reflexive agents in gradual change, but differs regarding how social actors might create and shape off-path change.

Luong (2002) underlined how established social elites shaped the form and degree of electoral reform adopted. Those who envisioned their interests expanding with transition duly adapt existing institutions in order to gain additional benefits whereas others perpetuate whatever maintains their existing distributional advantage. Hence, the extent of institutional change versus continuity fundamentally depends upon power shifting between different interest groups. In their historical analysis of active money management practice in US mutual funds, Lounsbury and Crumley (2007) employed the concept of “institutional entrepreneur” as powerful actors for bringing about innovative practice. Lounsbury (2001, 2007) also criticized the structural emphasis on institutional stability for neglecting the role

¹² According to Emirbayer and Mische (1998), they have to “contextualize past habit and future projects within the contingencies of the moment.

of such actors as regulatory agencies, mutual funds, portfolio managers, as well as academics. Although academic theorization part enabled active money management practice, new innovations were still challenged by longstanding mutual funds and industry insiders. It was the further diffusion of new practice that made active money management more legitimate.

3.5 Path Generation, Chinese SSG Reform and Further Propositions

It is now important to link path-generation to Chinese SSG reform. A critical element in current reforms is the so-called “creation of the modern enterprise system” among state owned enterprises previously caught between responding to market incentives while complying with state directives (Ewing, 2005). Researchers (e.g. Qian, 1996; Nee and Cao, 1999) often invoke the concept of path dependence to explain SOE's unaddressed problems regarding the legacy and interest entrenchment from the past communist era. In particular, they emphasize how the persistent influence of Chinese party-state in both firms and markets mediates efficiency-oriented goals and obstruct more radical institutional change (e.g. Tenev et al., 2002; Pei, 2009; Yeung and Liu, 2008).¹³ Although China's SSG might change for both external and internal reasons, the “punctuated equilibrium” model favoured among path dependence theorists implies that institutional deviation can sometimes occur in revolutionary rather than evolutionary manner (Leca et al., 2008). This contrasts strikingly with the actuality of radical institutional reform being potentially precluded by incremental and cumulative transformation from the very beginning. Thus, by emphasizing the “stickiness” of China's past institutional legacies, the path dependence perspective might better explain continuity, without specifying which particular forces have shaped or/and changed governance practices (Peters, 2005, p. 76).

The transitional nature of China's state sector suggests several interrelated aspects making institutional arrangements conducive to path generation. First, market transition has brought economic growth while intensified competitive pressure required many SOEs to readjust. Divisions between state influence and market efficiency have assumed greater significance. An expanding, if incomplete, market economy seeks greater economic and political

¹³ The concept has further been extended to investigate linkages between current Chinese Company Law and its jurisprudential rootage (Deng, 2008). Along its evolutionary trajectory, current Chinese Company Law displays strong “rule-driven” path dependency regarding the commercial law system transplanted from the West during the 1920s. For Humphery-Jenner (2012), the distinctive governance problems faced by Chinese reformers are also rooted within those customary Chinese cultural characteristics which emphasize unity and uniformity.

participation, which itself requires more varied governance institutions. Even if path dependence accepts the dynamics of adaption (such as positive feedback and complementarity), there must be mechanisms to recognize and remedy any evident maladies (Peters, 2005, p. 79). A path generation perspective could help explain how changes in the broader socio-economic environment induce more innovative SSG practices.

Second, political pressure pushes the SSG system to evolve differently (Dacin et al., 2002). A failure to foster effective regulation and sound governance practices could eventually jeopardize overall economic reform, and thus erode party-state legitimacy (Ewing, 2005; Pei, 2009). The adverse effects of regulatory failures and/or inferior governance practices can reduce the ruling party's ability to secure and expand its own key constituencies. A series of scandalous corporate failures, such as the collapse of Guangdong International Trust and Investment Corporation (1998) and Sanlu Milk scandal (2008) have brought evident public discontent and calls for further governance reform (see MacGregor, 2012). In sum, the redefinition of the party-state's role in economic and political life clearly impacts upon China's state sector, and path generation emphasizes the constraining as well as the enabling attributes of related political factors.

Third, like other governance institutions, the SSG system has to manage and reconcile the different relationships and interests of various different constituents, including government agents, controlling and minority shareholders, managers, employees, customers as well as any wider public (Lipton and Rosenblum, 1991). The ownership diversification and growth of the non-state sector have increased the range of actors in SSG and their further interaction increases duly increases the possibility of further reform. With its emphasis upon political coalition and manoeuvring, path generation gives scope for more fruitful description and explanation for endogenous institutional change (Leca et al., 2008). Finally, gradualism has moved the current SSG system into something more like a hybrid mode where complexity and incoherence allows innovative actors to "spring path dependence traps" (Orren and Skowronek, 2004; Crouch, 2005, p. 94). This could bring about off-path changes with emergent qualities. For Crouch (p. 143), "it is an environment that maximizes institutional choices".

In sum, there are few compelling reasons why understanding of China's SSG system should remain "locked in" to a static conceptual framework or preclude further inquiries into change. There is no necessary sense of regular periodicity where long periods of stability are

interspersed with rare moments of change. Political scientists (e.g. Garud and Karnøe, 2001; Campbell 2004; Streeck and Thelen, 2005) have lately moved away from the bifurcated typology of powerful institutional entrenchment and rare and radical change.¹⁴ In their view gradual but transformative institutional reforms generally occur in a series of successive and cumulative stages with a number of intra and extra-system mechanisms that “open up” the possibility for institutional transformation. Although less dramatic than abrupt and wholesale reforms, these slow and piecemeal transformations can be equally consequential (Mahoney and Thelen, 2010). In the light of the above, this thesis proposes that:

Proposition 1: Rather than become locked into self-reinforcement among entrenched institutions, China’s SSG system will progressively deviate from past central planning, leading towards other distinctive characteristics.

As a powerful engine of interest redistribution, SOE reform often provokes contestation among social actors over “the size and incidence of its costs and the apportionment and generosity of its benefits” (Mahoney and Thelen, p. 123). Where the concept of path generation is proposed to facilitate more understanding of how reform occurs, more attention should be devoted to interactions among leading change agents. These are groups of individuals or an organized body who have the *resources* and *power* to shape how particular institutions or/and institutional change (Daci et al., 2002; Seo and Creed, 2002; Mahoney and Thelen, 2010). Although this process might prevent any single actor taking full control, path generation arguments suggest that deviation from existent institutions are often carried out by motivated change agents through deliberate manoeuvring (see Bercovitz and Feldman, 2008). For North (1993), such change agents are often actors who respond most to the incentives provided by current institutions.

The history of economic reform suggests that Chinese central policymakers are influential players throughout (Wright, 2010). A continued interventionist approach has generated wide-ranging debate with two competing assessments regarding the possible policy outcomes. Neoclassical economists see reform trapped in a semi-marketised and increasingly predatory development logic where reform measures simply revitalize and extend the legacy of central control and planning (see also Pei, 2009). Efforts to improve investor protection and

¹⁴ Some path dependence theorists do recognize the possibility for incremental changes. However, they tend to conceive of these changes as fundamentally adaptive and serving to protect institutional continuity (see Thelen, 2009).

operational efficiency have encountered the party-state's reluctance to relinquish ownership and personnel control (Jung, 2011). The stated policy agenda is increasingly at risk of being hijacked by other entrenched interests (Smuthkalin, 2011). As noted by Pei (2009), China's limited political reform makes it difficult to contrast those institutions elsewhere believed to be critical to well-functioning SSG.

Nevertheless, the success of newly industrialised countries (NICs) (such as Japan, Korea, Singapore and Taiwan) suggests that a modern developmental state could also provide countervailing advantages for economic development (see Ortmann, 2011; Ringen et al., 2011; Chang, 2012). In contrast to countries which adopt a laissez-faire approach to economic governance, countries whose governments are more interventionist often formulate and implement developmental goals in an authoritative and binding fashion. In designing or/and reforming institutions, policymakers are here able to prioritize strategic goals and mobilise others to implement them. Accordingly, these countries have transformed the structure of their economies, become more globally competitive, and grown rapidly through continued investment in human capital and infrastructure development (Evans, 1995; Leftwich, 1995; Fine, 1999; Wong, 2004). For theorists of the developmental state (e.g. White and Gray, 1988; Nee et al., 2007), of China's state sector reform could pursue the dominant developmental paradigm of Asian NICs, which rested upon strong authoritarian leadership and professional bureaucracies implementing developmentally oriented policies. For example, Walder's (1995; 2002) argument of "local state corporatism", as characterized by Peng (2001) as "corporate governance approach", explained the prosperity of Town Village Enterprises (TVEs) as a result of fiscal decentralisation which provoked local officials to promote economic development within their jurisdiction. So, when government had "clear incentives and the ability to monitor firms and enforce their interests as owners", it replaced the entrepreneur as the mechanism driving the firm's performance improvement (Nee et al., 2007, p. 20). Empirical studies suggest that, with significant ownership stakes, state shareholders have both incentives and capacities to overcome problems such as information asymmetry and insider control elsewhere associated with dispersed shareholding, thereby ensuring decisions enhance firms' long-term value (e.g. Shleifer and Vishny, 1997; Bai et al., 2004; Tian, 2005; Culpepper, 2010). In this case, the state's "grabbing hand" has become a "helping hand" for promoting better regulatory oversights and CG practices (Frye and Shleifer, 1997), hence:

Proposition 2: Where the interaction between change agents determines policy outcomes, the significant economic and political interests of central policymakers make them leading change agents for China's SSG reform.

Although both policymakers and listed SCCs “have adopted the trappings of western companies”, research suggests that governance practices can still leave much to be desired (Thomas and Andrew, 2007). The observed gap between original intention and actual outcomes in governance reform has been attributed to mediating effects of the socio-political reality (Wu, 2005). Institutional complementarities impact upon the efficacy of chosen governance systems, and consequently the absence of necessary economic and political conditions makes it difficult to transplant governance mechanisms. For Naughton (1996) and Qian (1996) enterprise reform has often encountered resistance towards freeing markets in practice if not principle and, where bureaucratic control persists, SSG reform has been particularly contested, and held subordinate to other party imperatives. Resistance from the vested interests is most likely in sectors that bear significant economic rents. To the extent that interests groups became further entrenched, half-hearted and short-term measures have brought criticism of reformist leadership “shying away from decisive reforms” (Pei, 2009, p. 131). Moreover, already inefficient mechanisms may be further manipulated by skilled actors to serve their own interests, where manipulation refers to the “purposeful and opportunistic attempts to co-opt, influence, and control institutional pressures and evaluation” (Oliver, 1991; p. 157), hence:

Proposition 3: China's SSG reform encounters constraining or/and mediating forces from prevailing socio-economic conditions, in particular entrenched interests from prior institutional arrangements.

SSG systems shape how actors' particular interests are defined, aggregated, and represented with respect to any given firm (Aguilera and Jackson, 2003). From an actor-centred standpoint, chosen practices also result from strategic interaction between actors and their institutional environment, generating shared beliefs and norms that, in turn, affect whether and these interactions continue (Aoki, 2001a; Pretty and Ward, 2001; Aguilera and Jackson, 2003; Huse, 2005). SSG institutions have thus been “continuously created and re-created by a great number of social actors with divergent interests, varying normative commitments, different powers, and limited cognition” (Streeck and Thelen, 2005, p. 16; see also Pearson, 2007; Heilmann, 2011). It is reasonable to expect that change agents may resort to

innovative policy options to overcome other powerful institutional constraints, particularly where the makes radical change difficult. A changing political-economic landscape can enable key social actors to be more active throughout the reform process (Bradley et al., 1999; see also Heilmann, 2011; Rodrigues and Child, 2008; Jing and McDermott, 2012), thus:

Proposition 4: To the extent that entrenched institutions exert powerful constraints, strategizers may resort to different path-generation mechanisms to create innovative policy options to ameliorate governance shortcomings.

3.6 Summary

This chapter has surveyed selected neo-institutionalist literature about change, with particular attention to progressive institutional transformation among transitional economies' state sector. It has contrasted deterministic path dependence as a stochastic sequential process with more open and flexible alternative of path generation, arguing that the latter might better advancing existing understandings of Chinese SSG reform (see also Martin, 2006, 2010). Although it is now becoming more widely applied, Crouch (2005, p. 79) cautioned that "path dependence should not be seen as necessarily characterizing all institutions" however. Whether from a path-dependence or path-generation perspective, researchers encounter tension between developing a relatively simple model that forms the substance of institutional change while also portraying its actual complexities in more realistic 'action' terms. To this end they might employ concepts and formulations from multiple schools of thought and dwell at length on the insights available from more singular institutional perspectives. As Hall (2010, p. 220) stated, "it seems short-sighted to cling to one at the expense of benefiting from the others". Moreover, path generation requires a dynamic methodology to realize its potential advantage for studying Chinese SOE reform. It particularly requires more appropriate measures to capture the retrospective, prospective and real time narratives running through reform. It suggests the importance of applying a "real time" or chronological approach to capture both manifest details and the underlying (emerging) plots that give real meaning to changes occurring at different stages of institutional evolution, in closer approximation to where and when events actually occur (see Porac, 1997). Otherwise, it would be tempting to think of any sequence of events (retrospectively labelled as a path) as almost having been inevitable. The complexity of path generation suggests that these policy outcomes are far from uniform across different

domains and may only become suitably understood in retrospect. It is equally important to engage and follow the key players to appreciate their own entanglements and actions (Callon et al., 1986; Latour, 1991). This now raises the question of how to customize the most appropriate research methods for this purpose (Herrmann-Pillath, 2010).

Chapter 4

Research Design and Methodology

4.1 Introduction

The dynamic nature of institutional change poses significant methodological challenges. Hurmerinta-Peltomäki and Nummela (2006, p. 440) indeed argued that “if a narrow methodological approach were to be applied in this complex context, only a small slice of the reality would be revealed”. Moreover, state sector governance (SSG) in transitional economies is a relatively new field of research for which the necessary theoretical roadmaps have not yet emerged. Nevertheless, this provides scholars from various disciplines with the opportunities of applying innovative research methods to answer questions of growing importance. In this chapter, a mixed-methods approach has been proposed because it is an expansive and creative form of research that enables researchers to use multiple approaches and data sources to understand complex phenomena, including enterprise reform (Johnson and Onwuegbuzie, 2004; Bazeley, 2008, p. 135). Research on reform of China’s state-owned enterprises (SOEs) often focuses on the (statistical) correlation between enterprise performance and particular corporate governance (CG) practices at firm level. However, findings from such a ‘snapshot’ approach are limited in that they underestimate how systematic SSG can be, while the actual process and context whereby particular institutional arrangements emerge are not always sufficiently explored (Smoke et al., 2006; see also Williams and Zumbansen, 2011).

The next section (section 4.2) considers the rationale of a quantitatively embedded case study and discusses the particular research context into which it fits. It specifies the research objectives and identifies the potential problems of overreliance on just a statistical approach alone. The relative merits of a mixed-methods approach is then discussed in terms of its potential to mobilize multiple theories and data sources when examining particular SSG practices, thereby combining breadth and depth in empirical inquiries while improving the validity of findings (see also Modell, 2010). The following sections (sections 4.3 to 4.6) detail the procedures followed for data collection and analysis in the “building up” of more general theoretical accounts. To generate meaningful insights, considerations are given to how to conduct interviews with Chinese social elites, and also to analyse qualitative data

gathered through largely unstructured interviews, with particular attention to ensuring its validity for these purposes.

4.2 Strategy of Inquiry: A Quantitatively Embedded Case Study

The context-dependent, cross-disciplinary and open ended character of SSG as a field of research and the wide variations in its theoretical underpinning are apparent (Hopt, 2011). Such conceptual variations have significant implications for the methodological approaches employed. However, before detailed research design, the strategy of inquiry should primarily be driven by what questions research seeks to answer.

4.2.1 Research Objectives and Implications for Research Design

In prevailing finance and accounting studies, researchers often embrace a principal-agent perspective and thus focus exclusively on interest alignment/misalignment between corporate insiders and finance providers (Jensen and Meckling, 1976; Fama and Jensen, 1983; Eisenhardt, 1989). To the extent that socio-economic contexts vary, problems in China's state sector differ significantly from developed markets, as do mechanisms for correcting governance failings (Berglöf and Thadden, 1999). It may therefore be less fruitful to test established finance and economic theories not carried forward far beyond more advanced economies.

Such neoclassical theories affect methodological choices in the sense that the dominant approach has often been limited to positivist, quantitative methods, including the application of econometric techniques based on relatively large scale formal datasets (Megginson and Netter, 2001; Brennan and Solomon, 2008). They often emphasize selected facts and relationships between CG practices and particular performance proxies among reformed SOEs, where the former are delimited into measurable and common categories also applied to wider and/or similar research topics (Winter, 2000). A focus on statistical correlation may miss how CG arrangements are products of the broader SSG system (see Roe, 2003; Pagano and Volpin, 2005). These arise formally from set regulations and policies that in turn reflect the leading political institutions and developmental strategy of a given country (Anguilera and Jackson, 2003; Nolan, 2007). As a result, the systematic and embedded character of SSG can be underestimated. Moreover, where variables are measured and regressed over relatively short time periods, this approach may also neglect the ongoing dynamics of SSG reform and not fully capture the actual complexities in more realistic 'action' terms.

For SSG research in emerging economies, Lichet et al. (2005; see also Anguilera and Jackson, 2003) and Herrmann-Pillath (2008) suggest that research design should be receptive to how the SSG system has been shaped by interaction between multiple actors, i.e. actor-centred institutionalism, and evolves within the broader social-economic environment, i.e. institutional embeddedness. This research study differs significantly from prevailing finance and accounting studies. It seeks to explore the real dynamics of China's state sector reform, with special attention to the context, process and actors involved. It does so by firstly examining the different sources and mechanisms for institutional change, as well as the key actors and other context-specific elements of special relevance to China's specific institutional environment (Chapter 5). Using a firm-level case study, it also seeks to gain more insights into the reform process and interactions among the specific "local strategizers" who actually perform and even reform governance practices (Chapter 6). Both chapters apply embedded quantitative analyses to assess the policy outcomes of the ongoing reform. By examining the correlation between cumulative abnormal returns (CARs) – as proxies for stock market reaction on decision of cross-border mergers and acquisitions (CM&As) – and governance variables, it is possible to interpret how public investors – the key corporate constituents – regard firm-level policy arrangements in an increasingly international context. These findings may foreshadow further institutional evolution, granted the rising influence of public investors. This approach can enable researchers to explore the main constraints and impetus underlying the transformation process, and how the intertwined forces of institutional entrenchment and economic liberalization have led Chinese SSG further along the path of institutional transformation.

4.2.2 A Mixed-Methods Approach

A mixed-methods approach has formally been defined by Johnson and Onwueabuzie (2004, p. 17) as "the class of research where the researcher mixes or combines quantitative and qualitative research techniques, methods, approaches, concepts or language into a single study". Moving beyond previous debate, they claim that a mixed-methods design refers to a third research strategy which is situated in the middle.

"The goal of mixed-methods research is not to replace either of these approaches but rather to draw from the strengths and minimize the weakness of both in single research studies and across studies. If you visualize a continuum with qualitative research anchored at one pole and quantitative research anchored at the other, mixed-methods research covers the large

set of points in the middle area. If one prefers to think categorically, mixed-methods research sits in a new third chair, with qualitative research sitting on the left and quantitative research sitting on the right side” (Johnson and Onwuegbuzie, 2004, pp. 14-15).

Thus, by understanding the relative strengths and weaknesses of quantitative and qualitative methods, it is possible to mix these two strategies under what Johnson and Tuner (2003) term the fundamental principle of mixed-methods research. A range of well-rehearsed evaluative studies about the mixed-methods strategy emphasize its relative merits in validating data and analysis through triangulation, while gaining a fuller picture of the phenomenon under investigation (Mason, 2006).

The choice of a mixed-methods approach for this research study can be justified by the following reasons. First, the mix of quantitative and qualitative methods, albeit with unequal emphasis on each, provides a more enriched and elaborate understanding of SSG reforms. Although the merits of quantitative analysis lie in its generalizing inference and making of predictions, the conclusions from such inferences can be too general and abstract to be applied among specific local situations, contexts, and actors (Onwuegbuzie and Johnson, 2004). In other words, it runs the risk of premature theoretical closure (Modell, 2009). By conducting *post-hoc* qualitative research, researchers can uncover other complex dynamics and interactions behind statistical correlations. These may include tacit phenomena and processes related to the decision-making, implementation and further development processes of corporate governance.

Second, SSG represents an institutional configuration that operates at multiple levels (i.e. firm, market and nation) where a series of different institutional, economic and organizational factors shape organizational and governance practices (see OECD, 2005; Judge, 2011). While a large sample based statistical analysis enables outline investigation of developing Chinese SSG practices at large, complementary in-depth and customized case studies are also necessary to elaborate the transformative process and actors' interactions at both national and organizational levels.¹ The configurational character (of corporate governance) suggests that a multi-level analysis employing both quantitative and qualitative methods is needed, with each contributing cumulative knowledge about reform dynamics

¹ As noted by Creswell and Clark (2007, p. 91), “the premises of this design are that a single data set is not sufficient, that different questions need to be answered, and that each type of question requires different types of data”.

(see also Bazeley, 2008, p. 134).

Third, the integration of different data sources and analytical techniques may produce new and even surprising findings that would not have emerged otherwise. Paradoxical findings from quantitative analysis may prove helpful for designing the subsequent case studies and unstructured interviews; the findings from this may capture more about the key research questions. Thus differences in results generated through a mixed-methods approach can be welcomed as “it is in the tension that the boundaries of what is known are most generatively challenged and stretched” (Greene and Caracelli, 1997, p. 112; see also Bazeley, 2008). Although aligning any disparate findings thereby derived can require more time and effort it can also expand knowledge and increase any theoretical contribution (Hurmerinta-Peltomäki and Nummela, 2006).

Last, the so-called soft and/or invisible feature of certain governance institutions suggests the potential inappropriateness of solely relying on quantitative analysis (see Pierre, 2000). The decision-making and implementation of the particular corporate governance practices which this research study seeks to explore can be difficult to articulate, measure, and quantify. As noted, this is highly sensitive to the institutional environment and social actors’ interactions where “events are unpredictable and sporadic; outcomes are hard to specify; coalitions are transient; and the environment is extremely complex” (Shaffer, 1995, p. 509).² This is especially the case for emerging and transitional economies where judgment upon new corporate governance institutions is still premature (Peng and Heath, 1996; Estrin and Prevezer, 2011). Quantitative researchers who overlook the mediating effects produced by institutional or cultural factors can find it difficult to account for the unintended effects of ‘borrowed’ or ‘transplanted’ governance institutions. Thus, this research study will be contextually grounded, and seek to “understand process dynamics and not just outcomes” (Pettigrew, 2013, p. 124).

4.3 Research Design: A Quantitatively Embedded Case Study

Given the exploratory nature and the qualitatively-driven logic, a “quantitatively embedded research” has been chosen as the primary methodological design where quantitative analyses are “nested” within the predominant qualitative approach. Whereas the qualitative analysis

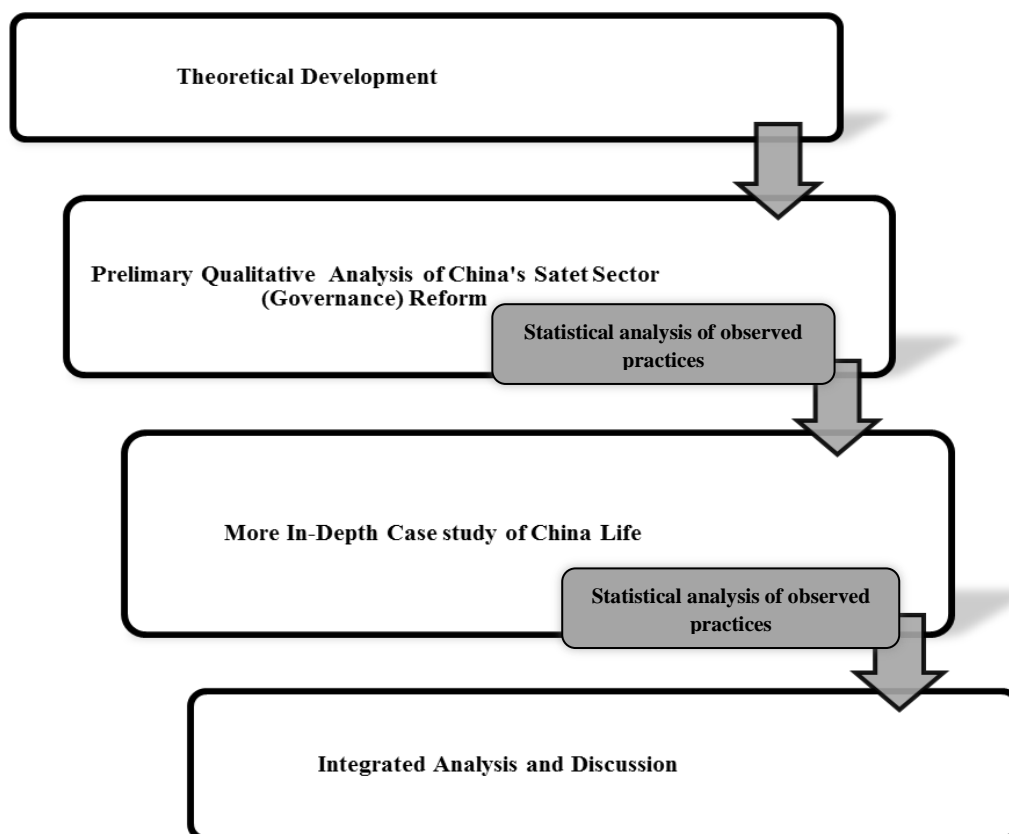
² Moreover, the social-cultural embeddedness of corporate governance suggests that informal rules are of equal importance in understanding the actual functioning of institutions at work.

may “lean towards prevalence, generalizability, and calibration”, the qualitative case studies are designated to give greater emphasis to narration, description, interpretation, and exploration (Pettigrew, 2013, p. 124).

4.3.1 Research Procedures

Figure 4.1 indicates a mixed-methods notation which depicts these procedures. Prior to data collection and analysis a conceptualization of China’s SSG reform has been advanced whereby theories from various disciplines are fused into an orienting lens that shapes the types of questions asked, participants interviewed, and data collected (Creswell, 2009, p. 207). The theoretical underpinning of this research study is largely drawn upon the political-economic perspectives and emerging theories of institutional innovation, in particular path-generation theory.

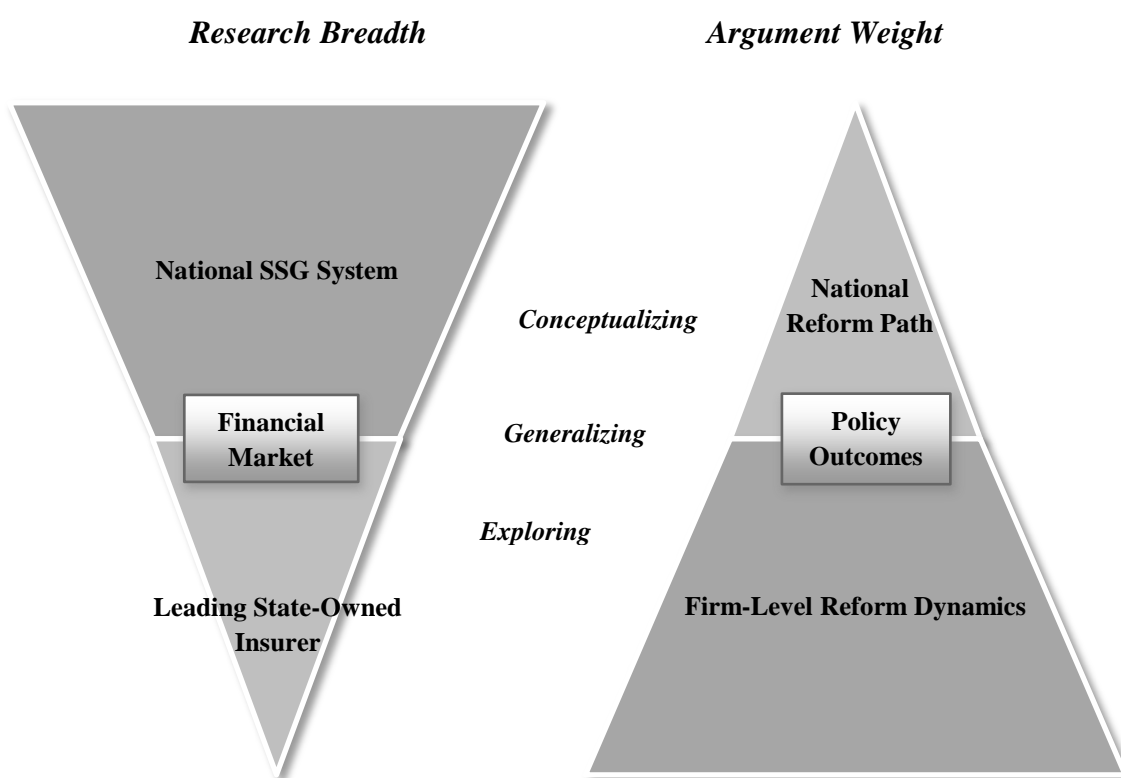
Figure 4.1 Quantitatively-Embedded Design



Theory building is then followed by data collection and analysis. In this stage, the quantitative data and analyses are embedded within two respective qualitative studies. Convergence of results from two different methods can help to generalize qualitative findings when quantitative data are based on random samples of sufficient size (Johnson and

Onwuegbuzie, 2004). Moreover, qualitative case studies allow the problem under discussion to be more exhaustively elaborated (Srnrka and Koeszegi, 2007). For Patton (2005, p. 3), “qualitative findings in evaluation can illuminate the people behind the numbers and put faces on the statistics to deepen understanding”. Such an *elaboration model* is considered effective for deriving deeper insights and building confidence from empirical evidence. The subsequent representative case study plays both *exploratory* and *complementary* roles. The purpose is to deepen inquiry into transformative dynamics through unstructured interviews with key decision makers (Creswell and Clark, 2007, pp. 86-91). For Morgan (1998), this embedded design is more applicable when testing the elements of an emerging theory (in this case, the path-generation perspective) derived from the qualitative phase before further generalizations are sought (Creswell, 2009, p. 211; Greene et al., 1989).

Figure 4.2 Breadth of Research and Weight of Findings



It can be seen that such a quantitatively-embedded design operates on three levels (see Figure 4.2), each with such functions as conceptualizing, generalizing and exploring (Scholz and Tietje, 2002, p. 30-31). The qualitatively-driven logic implies that, as empirical investigation deepens (as indicated by the inverted triangle), the weight of research findings is gradually shifted onto the single case study, which affords more fruitful insights into the

dynamics of SSG, including important issues often omitted in the finance-economic paradigm (Bansal, 2013).

4.3.2 Primary Qualitative Analysis

This stage has similarities with clinical case study design where path-generation theory and other political-economic perspectives have been used to ‘diagnose’ the causal links between different reform schemes as well as their policy outcomes. It differs from other case studies in the sense that it focuses on the transformative dynamics and interaction with social actors of corporate governance reform.³ So far, research into Chinese state sector reform has often been limited to the chronological review of different regulatory stages. Attempts to trace the precedence of one particular governance practice or the other in terms of chronological order may prove less fruitful as isolated instances of similar occurrences can be found in other stages of state sector reform (Tunzelmann, 2003).

Rather than imposing a “hypothesized end-state” onto China’s reform destination, this study uses path-generation theory as its conceptual anchor as it underscores the emergent nature of SSG reform. While the transformation of governance institutions can be highly situational, the concept of institutional entrepreneur highlights the role of actors’ self-awareness and self-interests, as well as their interaction with the existing institutional arrangements, in explaining the emergence and stabilization of certain practices. All these might require researching archive resources, including formal reports, government documents, newspaper, and documentary films where these are sufficiently rich to admit subsequent reinterpretation (Adelman et al., 2012). With synchronous (real time) information regarding institutional development researchers can situate themselves at the very time when events occurred, even if looking at data gathered in the past (Bijker et al., 1987). Otherwise, it would be tempting to think of any sequence of events (retrospectively labelled as a path) as having been inevitable. It is also possible to follow different actors to study how actions become possible through mutual entanglements (Reven et al., 2011; Douglas, 2012). The qualitative inputs can illuminate their complexities and embeddedness from an action perspective which statistical regression cannot necessarily illuminate. The following study underscores salient governance features in a leading Chinese context in a way which could facilitate further empirical studies.

³ It also seeks to provide the most updated overview of China’s corporate governance reform as the latest available research on the same topic were conducted during the early 2000s.

4.3.3 A Single-Case Study

This provides a firm-level investigation into the actual evolution and implementation of SSG practices, with a particular focus upon the role of local actors. Its aim is to increase the thoroughness of previous research findings through a more comprehensive and intensive rooted in both the representativeness and practicalities of SSG institutions. The selected company is a leading large state-controlled corporation (SCC) in China's insurance industry – China Life Insurance Company Limited. It is a leading representative example of the state governance movement among China's larger SOEs and this research is exploratory because:

- China Life has undergone critical developmental stages including establishment as a state-run unit, expansion of managerial autonomy, corporatization, spin-offs of non-performing asset, and stock market listing. Its predecessor, i.e., People Insurance Company of China (PICC), was approved and established the same year as the founding of the People's Republic of China in October 1949 when it became the only officially approved insurer. With increasing deregulation and globalisation, China Life has transitioned from an administrative unit attached to the People's Bank of China, to major market player faced with intensified competition. In certain respects the history of China Life mirrors the evolution of much of China's state sector.
- The Company has the prevailing concentrated shareholding structure of China's state sector in spite of further attempted ownership diversification. It is near typical for Chinese SCCs that the majority ownership stakes are retained by intermediate shareholding agencies. The 2012 annual report showed that the shareholding group, i.e. China Life Insurance Group, maintains 68.37 per cent ownership control over the listed entity. In accordance with Company Law, China Life also adopted the dual-board system for internal corporate control, with the board of directors responsible for major decision-making. A highly concentrated shareholding structure implies that the Company is likely to face the same problem of insider control found among other SCCs (see also Wu, 2005; Naughton, 2006).
- In terms of administrative status and regulatory framework, the Company enjoys the same vice-ministerial level ranking as many other Chinese "national champions". While most of these corporations are subject to State Asset Supervision and Administration Commission (SASAC) supervision, the Company and state-owned banks have similar superior regulatory bodies, i.e. Chinese Insurance Regulatory Commission (CIRC) and

Chinese Banking Regulatory Commission (CRBC). With the party-state's continuous manoeuvrings to improve the state asset management system among non-financial corporations, there have been robust debates about whether the equivalent asset management body should be enacted and reconsolidate state control over the insurance and banking sectors (Naughton, 2006). Thus, it will be intriguing to investigate how similar reform measures have been implemented within the state-owned insurance giant, which may shed light on future policy changes. So far there have been few firm-level studies about China's insurance sector even while its regulation has undergone dramatic transformation.

- The Chinese party-state adopted overseas listing as an important means of raising capital and imposing more effective corporate supervision. China Life was successfully listed in the New York Stock Exchange and Hong Kong Stock Exchange on December 17 and 18, 2003, respectively. This made it the first state-owned financial enterprise to launch its overseas initial public offering (IPO), raising \$3.5 billion and becoming the world's largest IPO of that year. The Company was also among the first group of China's SOEs that voluntarily subjected themselves to emerging international corporate governance standards. The governance practices within these "pilot" companies at both national and firm levels may bear important policy implications for other national champions seeking overseas listing.
- Under the World Trade Organization (WTO) accession in 2001, restrictions over many business sectors regarding ownership type, business scope, and geographical area were to be gradually diminished. It might reasonably be expected that the semi-monopolistic position of many large SCCs could be challenged by new entrants, including major international and domestic non-state competitors. The increased 'openness' and competitive pressure of China's insurance sector implies greater chances for off-path institutional innovation while also foreshadowing the further development of state governance amid intensified marketization.

This sampling logic contrasts strikingly with hypothesis-testing research in which the goal of sampling is to obtain accurate statistical evidence on investigated variables within a large population (Eisenhardt, 1989). As Pettigrew (1990, 2013) noted, due to the limited number of cases which can actually be investigated, it can make more sense to choose cases such as extreme situations or polar types where the process is "transparently observable" (see also Eisenhardt, 1989). So, by filling different theoretical categories or providing examples of

polar types, case sampling in theory-building research seeks cases likely to replicate or extend emergent theory. Similar sampling strategies are observed among prevailing research into SOE reform (see Nolan and Wang, 1999; Nolan, 2002, and 2005; Naughton, 2006, 2008).

Qualitative data was here obtained from organizational documents and actors with appropriate specialized knowledge which will be discussed in the following section. In particular, in-depth interviewing, and repeated close contacts with, and observations of, key informants were employed. The character of this inquiry is therefore relatively unstructured and mainly composed of unstructured interviews. A formal pilot study was not conducted since the two preliminary studies were intended to serve a similar purpose. The primary research participants include 36 interviewees, mainly corporate managers and party committee members, whose positions ranged from top level board members and government officers to individual department managers. The research design of multi-level interviews also aimed to provide in-depth and comprehensive insights into ongoing regulatory and governance practices in China's SCCs. For this purpose, the choice of a multiple case study approach has been rejected, as breadth might then be obtained at the expense of depth.

The channels for elite interviews derived mainly from the researcher's own relational connections within both SOE and government sectors, as well as past journalism work for a Swiss national newspaper, i.e. *Neue Zürcher Zeitung*. Furthermore, in order to gain due political perspective, interviewees included officials from the Chinese Communist Party (CCP) Central Finance Committee and China Insurance Regulatory Commission. Three interviewees from the Shareholding Group actively participated in the overseas IPO and were closely engaged in the initial preparatory stage of the subsequent lawsuit settlement. Table 4.2 shows the composition of the sample. For reasons of anonymity, names of informants and their detailed managerial tenure are not disclosed.

Table 4.1 Sample of Interviewees

Positions of Interviewees	Affiliated Companies and Departments	Interview Site and Year	Informant Code
Director	Investment Department of China Life Group Corporation	Beijing, 2009, 2010 and 2011	IN1
Director	Resource Configuration Department	Beijing, 2011	IN2
Former Independent Director	Board of Directors of China Life	Beijing, 2010	IN3
Former Secretary	General Manager's Office of PICC	Beijing, 2009	IN4
Former Secretary	Board of Directors of China Life	Beijing, 2010, 2011 and 2012	IN5
Director	President Office of China Life	Beijing, 2010	IN6
Former Supervisor	Board of Supervisor	Beijing, 2011	IN7
Former Deputy Director	HR Department	Beijing, 2012	IN8
Former member	IPO Roadshow Delegation	Beijing, 2010	IN9
Former member	IPO Roadshow Delegation	Beijing, 2010	IN10
Former Director	Sales and Marketing Department of China Life	Beijing, 2010 and 2011	IN11
Deputy Director	Audit Department of China Life	Beijing, 2010	IN12
General Manager	China Life Guangdong Provincial Branch	Guangzhou, 2010	IN13
Former Manager	Sales and Marketing Department of China Life Guangdong Provincial Branch	Guangzhou, 2010	IN14
General Manager	China Life Beijing Municipal City Branch	Beijing, 2010 and 2011	IN15
Deputy General Manager	China Life Beijing Municipal City Branch	Beijing, 2010 and 2011	IN16
Former Manager	Sales and Marketing Department of Beijing Municipal City Branch	Beijing, 2010 and 2011	IN17
Former Manager	Sales and Marketing Department of Yanqing County Branch	Beijing, 2010 and 2011	IN18
Deputy Director	China Life Northern China Audit Centre	Beijing, 2010 and 2011	IN19
Deputy Director	China Life Northern China Audit Centre	Beijing, 2010 and 2011	IN20

Table 4.1 Sample of Interviewees – Continued

Positions of Interviewees	Affiliated Companies and Departments	Interview Site and Year	Informant Code
Director	China Life North-eastern China Audit Centre	Shenyang, 2010 and 2011	IN21
Audit Group Leader	China Life North-eastern China Audit Centre	Shenyang, 2010 and 2011	IN22
Director	China Life Southern China Audit Centre	Shenzhen, 2011	IN23
Deputy Director	China Life Southern China Audit Centre	Shenzhen, 2011	IN24
Secretary	General Manager Office of China Life Common Wealth Bank Insurance Corporation	Shanghai, 2009	IN25
Former member	CCP Central Financial Work Committee	Beijing, 2009, 2010 and 2011	IN26
Former member	CCP Central Financial Work Committee	Beijing, 2009, 2010 and 2011	IN27
Senior Official	Law and Regulation Department of China Insurance Regulatory Commission	Beijing, 2010 and 2011	IN28
Senior Official	Law and Regulation Department of China Insurance Regulatory Commission	Beijing, 2010, 2011 and 2012	IN29
Defendant lawyer	Sidley Austin LLP	Beijing, 2010	IN30
Lawyer	Debevoise & Plimpton LLP	Beijing, 2010	IN31
Manager	Investment Department of Hutchison Whampoa	Shanghai, 2011	IN32
Manager	Investment Department of Hutchison Whampoa	Beijing, 2011	IN33
Former Manager	Investment Department of Hutchison Whampoa	Shenzhen, 2011	IN34
Senior Official	National Audit Office	Beijing, 2010	IN35
Senior Official	National Audit Office	Beijing, 2010	IN36

4.3.4 Embedded Quantitative Analysis: Event Studies

The quantitative analyses test findings derived from the preliminary qualitative research and single-case study set within an actively internationalizing context. Where the qualitative research examines the dynamics of SSG reform, complementary statistical analyses are expected to examine how international investors regarded observed different SSG arrangements, including corporate governance practices, given the growing influence of public investors in the key reform agenda (Green, 2003). The CARs are here intended to capture the reaction of international investors towards firms' decisions about cross-border mergers and acquisitions shaped by the observed SSG practices. In actuality, CARs are widely adopted to examine investors' ratings of particular institutional factors and governance arrangements that bear upon corporate strategic decision-making (e.g, Gubbi et al., 2009; Chen et al., 2010; Dhaliwal et al., 2011). The raw data was shared in a recent publication co-authored with Dr Lutao Ning, Dr Jing-Ming Kuo and Professor Roger Strange.⁴

4.3.4.1 Research Context

The statistical analyses use a relatively unique, manually constructed firm-level dataset to examine the stock market's reaction upon announcements of CM&As made by Chinese multinationals listed in the Hong Kong Stock Exchange (HKSE). Hong Kong provided an ideal setting for the following reasons. First, HKSE, owing in part to its geographic and historic links with the mainland, remains the favored hub for CM&A activities by Chinese MNCs (see also Sutherland and Ning, 2011). For example, statistics from Thomason One Banker reported that, among the 588 CM&As by November 2013, 171 were conducted through their listed entities in Hong Kong. Thus, research on CM&As by the mainland-listed MNCs often entail limited numbers of observations that could mean inconclusive findings (Zhao, 2001; Wang and Wang, 2011; Ning et al, 2014). For example, Boateng et al. (2008) examined a small sample of 27 Chinese cross-border acquisitions by mainland listed SOEs between 2000 and 2004 and concluded positive value creation for acquiring firms' shareholders. Using a sample of 39 deals during 2000-2008, Chen and Young (2010) find that Chinese acquiring multinational enterprises (MNEs) with greater government ownership generate lower value returns in CM&As. A recent study by Kling and Weitzel (2011)

⁴ See Ning, L., Kuo, J., Strange, R. & Wang, B., 2014. International Investors' Reactions to Cross-Border Acquisitions by Emerging Market Multinationals. *International Business Review*, forthcoming.

analyses 221 CM&A announcements by Chinese firms listed in the Hong Kong, Shanghai and Shenzhen and concluded that CM&As created less positive shareholder value than domestic M&As. Such scarcity can be attributed to Chinese CM&As being a relatively recent phenomenon (Nolan and Wang, 1999; Naughton, 2008).

Second, the mature and well-regulated Hong Kong stock market could provide more rational assessment of the governance characteristics of Chinese MNCs (Cheung et al., 2007). In contrast to mainland stock markets potentially dominated by inexperienced and speculative investors, Hong Kong has successfully attracted other international financial institutions and securities professionals. Their qualifications are internationally recognized with accumulated valuable trading experience to provide more critical financial and technical assistance to individual investors (Mei, et al., 2009). Moreover, Hong Kong has a well-developed financial market infrastructure reputedly known for relatively close and careful regulatory supervision (Cheung et al., 2007). In particular, more stringent corporate governance requirements ensure that investors have access to the more timely and transparent information necessary to appraise companies' position and prospects (Ho and Wong, 2001). In fact, international rating agencies often rank Hong Kong one of the most advanced markets in the Asian-Pacific region (Cheung et al., 2007). The announcement returns here reflect the more rational and objective responses towards individual CM&A decisions under different SSG arrangements (Lin and Wang, 2001).

Finally, a Hong Kong stock market also dominated by firms with concentrated ownership and intertwined management may well mitigate the 'home bias' in share pricing (Kumar, 2009; Ning et al., 2014). In contrast to the more dispersed ownership found in Anglo-American countries, Hong Kong listed companies exhibit a high level of ownership concentration among families, industrial groups, or governments (Dyck and Zingales, 2004; Cheung et al., 2007). This is obtained by dual class shares and/or pyramidal structures, as frequently found in companies from other East Asian economies, including the Chinese mainland (Ben-Amar and André, 2006). Governance problems and expropriation risk thus differ considerably from the conventional agency problem, as can the corresponding solutions and regulatory means (La Porta et al., 1998; 2000; Claessens et al., 2002; Claessens and Fan, 2002). Such contrasting ownership and governance arrangements could imply an inherent "home (local) bias" in stock valuation where investors exhibit greater

aversion to foreign securities (Tesar and Werner, 1995; Coval, and Moskowitz, 1999; Kilka and Webber, 2000; Kumar, 2009).

4.3.4.2 Sample Size and Variable Definition

The dataset combined both electronic sources and manually collected information. A near exhaustive sample of 504 CM&A announcements made between 1 Oct 1991 and 31 May 2010 were extracted, mainly from the Thomson One Banker. Additional entries were collected from other databases, including the business information services from Factiva and LexisNexis, in order to develop a more comprehensive proprietary database, as there were more than 120 missing Chinese CM&A cases in the electronic database. The integration of multiple data sources effectively expands the sample size.

The dependent variable of CARs measures the total returns to shareholders attributed to CM&As announcements (Boardman et al., 2010). It reflects investors' judgments regarding the value-creation (or destruction) potential of particular institutional and organization factors (Chen and Young, 2010; Gubbi et al., 2010; Ning et al., 2014). To calculate the CARs, stock price data over a period of 100 days prior to CM&A announcements were obtained through DataStream. 405 CM&As were identified after excluding companies with missing stock data. As discussed later, the large, cross-sectional event sample and the long timespan can mitigate the estimation bias of abnormal returns (McWilliams and Siegel 1997; Binder, 1998).

The independent variables include nature of corporate control, board characteristics, and other firm and deal-specific control variables. Where DataStream provided convenient access to control variables, the one-year lagged values regarding the governance characteristics were manually collected from each company's annual reports so that endogeneity issues could be resolved. The stringent information requirement by HKSE since 1999 enabled the researcher to extract important information regarding identity of corporate control, ownership structure and board composition (Chen and Young, 2010). The increased openness of e-government websites proved useful for verifying certain characteristics of SSG, including the inter-firm linkage and identify of ultimate corporate controllers. Thus, a subsample of 372 acquisitions over the period of 1999-2010 was used for the cross-sectional analysis. Table 4.3 provides the definition of variables adopted.

First, characteristics of corporate control formulate the institutional infrastructure of corporate decision-makings, and thus have significant influence over interest alignment among stakeholders and the value creation effect of CM&As (Jensen and Meckling, 1976; Shleifer and Vishny, 1997). As the number of private enterprises was limited, two binary variables – central government control and local government control – were adopted to denote the nature of firms’ ultimate controllers (see also La Porta et al., 1999; Anderson and Reeb, 2003; Tihanyi and Hegarty, 2007; Chen and Young, 2010; Wielemaker and Gedajlovic, 2011). The preceding qualitative analysis suggested different roles and incentives structures of central and local governments in enterprise reform, thus providing a rationale for detailed variable selection. To identify the ultimate controllers, each firm’s largest shareholder was noted first and, if the greatest shareholder was a business entity, an attempt was made to identify the controlling organizations (see also Lien et al., 2005). If the organization was a shareholding agency authorized by central government, the firm was categorized as central government controlled (CGC). Similarly, if a firm’s ultimate controller was an agency authorized by local government, the firm was considered to be local government controlled (LGC). As noted, the integration of various information sources, including media news, administrative documents and even government websites, facilitated data coding and entry. In the context of emerging economies, group affiliation increases the risk of investor expropriation, as the affiliated enterprises are often associated with lack of transparency, unclear management structure and possibility of expropriation (Liu and Lu, 2007). Thus, dummy of group affiliation (GA) was adopted (coded 1 if the acquiring firm was affiliated to a business group). Finally, the presence of a large shareholding may help to overcome the “free-rider” problem among minority investors in monitoring corporate management. A significant equity stake implies a high degree of congruence between the controlling shareholders’ interest and firm’s interests. A significant ownership stake implies that the controlling financée have both strong incentives and capacities to overcome the ‘free-rider problem’ associated with dispersed shareholding (Shleifer and Vishny, 1997; Bai et al., 2004; Culpepper, 2010). Thus, the numeric variable of largest shareholding (LS) was included, given its positive role in managerial monitoring.

The other set of explanatory variables relate to board’s characteristics. Corporate governance scholars have devoted considerable attention to examining the influence of boards on firms’ strategic decisions and performance. ‘Upper echelon’ theory suggests that board characteristics have considerable influence upon the outcomes of strategic decisions and thus

corporate performance (see Hambrick and Mason; 1984; Finkelstein and Hambrick, 1996; Lien et al., 2005). While firm-level case research showed mixed results regarding the efficacy of board institutions, cross-sectional analysis here was designed to evaluate their roles within the context of internationalization. These include board of directors (BOD), Supervisory Board (SB), and audit committee. According to the Company Law, Chinese companies adopt a two-tier or hybrid board structure in which independent director and supervisory boards are intended to impose effective managerial oversight. To agency theorists, increased board independence, as measured by the proportion of independent directors on boards, can ensure that firms' decisions are made in the interests of public investors and thus reduce the expropriation risks posed by corporate insiders. Research on corporate governance development outside an Anglo-American context suggests that independent directors may not mitigate insider control, give controllers' dominance over boards (see Peng, 2004). Although corporate supervisors are necessary for improving governance quality, their efficacy needs to be endorsed (Dahya et al., 2002). For example, findings from the Chinese context suggest that SBs in Chinese companies are not effective enough to establish "institutional legitimacy" in curbing insiders' malpractices. Corporate insiders can use their super voting rights to turn the board into a 'rubber stamp' authority by appointing members who would not challenge their decisions (Tam, 1995; Claessens et al., 2002; Peng, 2004; Xi, 2006). To public investors, expanded SBs staffed by incumbent executives are likely to incur significant administration and communication costs.

To gain a wider view, audit committee independence – measured by the proportion of external committee members – was included to proxy higher quality of internal control and information disclosure. Chinese firms listed in Hong Kong are often subject to more stringent information requirements and accounting standards imposed by foreign regulators and market participants. Higher committee independence is expected to positively discipline incumbent insiders (Chan and Li, 2008). In the light of the above discussion, variables of BOD independence (BI), supervisory board size (SBS) and audit committee independence (ACI) were included (see Bhagat and Bolton, 2008). Brickley et al. (1997) found that CEO/chairman duality (CD) can effectively enhance managerial monitoring through improved transparency of board meetings and information flow. In the Chinese context, Chen et al (2011) suggest that the role of duality may remain rather limited as board members and executives are commonly dominated by the unified "leading team" of shareholding agencies. Thus CD was included as a dummy variable to examine how

international investors judge the board efficiency of Chinese MNEs. In addition to the specialist literature, variable selection here drew upon preceding case research, and statistical inference was expected to enhance the generalizability and/or validity of such qualitative findings (see also Ning et al., 2014).

Meanwhile, drawing upon research on CM&As, the cross-sectional analysis controlled for both firm and deal-specific variables that might affect short-term deal performance. Firm age (FA) was included due to the positive effects of the learning curve on firms' internationalization performance (Sapienza et al., 2006). To control for the influence of firms' past financial and operational performance, the 3-year averages of return on assets (ROA) operating profit margin (OPM) have also been adopted. Firm size (FS) has often been interpreted as a value-creation indicator of firms' available resources and capability for achieving economies of scale (e.g. Bontin, 2001; Lien et al., 2005; Du and Boateng, 2012). However, existing international business literature suggests that expanded firm size may have significant value-destruction effects due to managerial hubris, information asymmetry and coordination challenges over post-acquisition integration (e.g. Stulz, 2005; Gubbi et al., 2010). This study did not have a direct measure of how much these factors took effect, but used Tobin's Q (TQ) as a proxy. The reasoning was that the above-mentioned effects could arguably become reflected in different market capitalization (Bontin, 2001; Doukas and Lang, 2003; Lien et al., 2005; Dong et al., 2006). Higher leverage, measured as debt-equity ratio (DER), may have a positive effect on CARs as financial leverage may reduce managerial discretion and indicate firms' capabilities to access external financial resources (Masulis, et al., 2007). As to the deal-specific effects, the nature of target firms is reflected in the dummy of target status (TS) (coded 1 if a target firm is private) (Fuller et al., 2002; Moeller et al., 2004). It has been documented in the M&A literature that status of target firms (i.e. private vs. public) is likely to influence acquisition performance (Capron and Shen, 2007; Gubbi et al., 2010). Acquisition of a private target fails to enjoy a reputation similar to that of public firms and is less likely to result in overpayment, implying greater wealth gains to acquirers' shareholders (Gubbi et al., 2010; Uddin and Boateng, 2011; Du and Boateng, 2012; Ning et al., 2014). The regression model also controls the impact of time-varying market-wide performance and re-adjusts t-statistics for the effect of industry clustering. A one-year lag was also assumed between the CM&A announcements and all the control variables.

4.3.4.3 Regression Procedure

Both analyses follow a two-step procedure in which (1) a standard event study methodology is used to access the value creation effect of corporate investment decisions;⁵ and (2) the resulting cumulative abnormal returns (CARs) are regressed on a series of explanatory and control variables regarding specific governance features in Chinese companies. This design has frequently been used in OFDI research into emerging economy corporations (e.g. Filatotchev et al., 2007; Gubbi et al., 2010). The statistical analysis here, including the CAR calculation and subsequent cross-sectional analysis, uses STATA as the primary research tool. The original syntax commands and statistical result are presented in the attached appendices.

To calculate the CARs, it is necessary to obtain the estimated coefficients. The standard approach of the market model in which the daily stock returns of a firm are regressed against the returns of a benchmark market index is applied for this purpose. The market model has been widely employed by the prevailing research on CM&As by emerging multinational enterprises (e.g. Filatotchev et al., 2007; Chen and Young, 2010; Gubbi et al., 2010; Ning et al., 2014). Its high R^2 suggested the great ability of detecting event effects (MacKinlay, 1997; Desai et al., 2005). The model is expressed as follow:

$$\text{Eq. (1)} \quad R_{it} = \alpha_i + \beta_i R_{mt} + \varepsilon_{it},$$

where R^2 is the observed return on firm i 's share price on day t . R_{mt} is the return on the selected market index, i.e., Hang Seng Index, on day t . The coefficient α_i is denoted as the intercept term and β_i captures the systematic risk of firm i 's share prices. ε_{it} is the random error term. Thus, the daily abnormal return on firm i 's share price within the event window can be expressed as:

$$\text{Eq. (2)} \quad AR_{it} = R_{it} - (\hat{\alpha}_i + \hat{\beta}_i R_{mt}),$$

where $\hat{\alpha}_i$ and $\hat{\beta}_i$ are the parameter estimates of α_i and β_i from the single-factor market model. They were computed through the ordinary least squares regression of R_{it} on R_{mt} over the predetermined 90-day estimation period, commencing from $t=-120$ to $t=-30$ prior to the event announcements. These two estimates, together with the observed return on firm i 's

⁵ Event study has been widely used by financial economists to investigate the financial impact of an unanticipated event, such as investment decisions and senior personal changes (McWilliams and Siegel, 2011).

share price and return on Hang Seng Index on day t , were then plugged into Eq. (2) to compute estimation error as a proxy for the daily abnormal return AR_{it} .

However, the simplicity of market model may lead to severe estimation bias, as any omission of firm-specific characteristics may increase the variance of abnormal returns (Binder, 1998). In this case financial economists (e.g. Sharpe and Sharpe, 1970; Bailey and Chung, 1995) have proposed multifactor models to incorporate sector- and/or size-related indexes in addition to the market benchmark. However, as noted by MacKinlay (1997), the gains from employing such models are questionable due to the limited explanatory power of the additional variables, leading to little reduction in error term variance (see also Brown and Warner, 1980, 1985). Variance deduction will typically be greatest in cases where sample firms are clustered in one industry or concentrated within one market capitalization group (MacKinlay, 1997). Binder (1998, p. 119) noted that variance of abnormal returns will average to zero “when a large sample of unrelated securities is used or the event dates are not clustered in calendar time”. In either case, the market model estimator of abnormal returns is generally unbiased.

The abnormal returns were further aggregated over the event windows period to obtain the cumulative abnormal returns. This event study employed the parametric t-test to test whether the CARs were significantly different from zero. To address issues of information leakage, it is necessary to test the CARs over different event periods (see Milevsky and Song, 2008; Chen and Young, 2010). Thus, various event windows, such as $(-5, +5)$, $(-2, +2)$, $(-1, +1)$, and $(-1, 0)$ were employed with the announcement date denoted as 0. According to McWilliams and Siegel (1997), these event periods should be long enough to capture the significant effect of the events, while short enough to exclude the confounding effects (see also Chen and Young, 2010). Binder (1998) suggested that bias in hypothesis test about average CARs depends on the number of observations in both the estimation period and event window. As the event period expands, the bias becomes substantial thanks to the time-series dependence (Mikkleson and Partch, 1988). For example, Cowan (1993) found that the uncorrected test statistic is the correct value by 1.6 per cent under the 100-day estimation period and 5-day event window. As the event window increases to 60 days, the bias will rise to 25.2 per cent (see also Binder, 1998). Thus, the shorter event window relative to the estimation period can also reduce the bias in hypothesis test (see also Karafiath and Spencer, 1991; Sweeney, 1991; Salinger, 1992).

At the second stage, the resulting CARs of the sub-sample were regressed on a series of control and explanatory variables to measure how international investors perceive the characteristics of corporate control, and the efficacy of the internal corporate governance mechanisms. The results can further validate the qualitative findings derived from case studies. The cross-sectional regression models are given by:

$$\begin{aligned} \text{Eq. (3)} \text{CAR}_i = & \alpha_i + \beta_1 \text{Firm Age}_i + \beta_2 \text{Firm Size}_i + \beta_3 \text{Tobin's } Q_i \\ & + \beta_4 \text{Debt} - \text{Equity Ratio}_i \\ & + \beta_5 \text{Return on Assets}_i + \beta_6 \text{Operation Profit Margin}_i \\ & + \beta_7 \text{Target Status}_i + \beta_8 \text{Group Affiliation}_i \text{ (dummy variable)} \\ & + \beta_9 \text{Ownership of the Largest Shareholder}_i \\ & + \beta_{10} \text{Central Government Control}_i \text{ (dummy variable)} \\ & + \beta_{11} \text{Local Government Control}_i \text{ (dummy variable)} + \varepsilon_i \end{aligned}$$

$$\begin{aligned} \text{Eq. (4)} \text{CAR}_i = & \alpha_i + \beta_1 \text{Firm Age}_i + \beta_2 \text{Firm Size}_i + \beta_3 \text{Tobin's } Q_i \\ & + \beta_4 \text{Debt} - \text{Equity Ratio}_i \\ & + \beta_5 \text{Return on Assets}_i + \beta_6 \text{Operation Profit Margin}_i \\ & + \beta_7 \text{Target Status}_i + \beta_8 \text{Board Independence}_i \\ & + \beta_9 \text{CEO/Chairman Duality}_i \text{ (dummy variable)} \\ & + \beta_{10} \text{Supervisory Board Size}_i + \beta_{11} \text{Audit Committee Independence}_i \\ & + \varepsilon_i \end{aligned}$$

Table 4.3 Variable Definition

Variables	Definition
CARs (-1, +1)	Cumulative abnormal returns of acquiring firms over the 3-day event window
Central Government Control (CGC)	Dummy variable: 1 for companies controlled and supervised by central government agencies, 0 otherwise
Local Government Control (LGC)	Dummy variable: 1 for companies controlled and supervised by local government agencies, 0 otherwise
Group Affiliation (GA)	Dummy variable: 1 for group affiliated, 0 otherwise
Ownership of the Largest Shareholder (LS)	Shareholding Percentages of the Largest Shareholder
Board Independence (BI)	Proportion of independent directors in the boards
Supervisory Board Size (SBS)	Number of supervisors in the acquiring firm
Audit Committee Independence (ACI)	Proportion of independent auditors on the audit committee
CEO/Chairman Duality (CD)	Dummy variable: 1 if the bidder CEO is also chairman of the board, 0 otherwise
Firm Age (FA)	Years of incorporation for the acquiring firm
Firm Size (FS)	Natural log of total assets at the end of last fiscal year
Return on Assets (ROA)	3-year average of acquirer's return on assets
Operation Profit Margin(OPM)	3-year average of acquirer's operating profit margin
Tobin's Q (TQ)	Market value of assets over book value of assets
Debt-Equity Ratio (DER)	Acquirers' debt-equity percentage
Target Status (TS)	Dummy variable: 1 for public target firms, 0 otherwise

4.4 Qualitative Data Collection in the Single Case Study

Qualitative data were gathered through a combination of elite interviews and document analysis. As noted by Thurmond (2001, p. 254), the merits of data triangulation entails “increasing confidence in research data, creating innovative ways of understanding a phenomenon, revealing unique findings, challenging or integrating theories, and providing a clearer understanding of the problem”. Moreover, the use of multiple data sources in a single study can often elicit various perspectives on a single issue or elaborate upon different aspects of research questions (Turmond, 2001). Guion et al. (2011, p. 3) suggest that the benefit of data triangulation relies on “the diversity and quantity of the data that can be used for analysis” and the scope reflected.

4.4.1 Elite Interviews

Field research was largely interview based. It differed from prevailing studies where there are few similarly first hand, in-depth, up-to-date studies of real top-level actors actually “doing strategy” in any kind of organization, let alone in an internationalizing Chinese business group. The need to access high level organizational actors as “strategizers” calls for the corresponding research methods, and therefore includes upper echelon theory, open-ended interviews, problem focused methods, rather than more conventionally “standardized”, impersonal, and non-customized questionnaires. The actor-friendly character of this inquiry makes elite interviews the preferred strategy for research, primarily because interviewees included high ranking key informants, ranging from company managers at provincial level to department directors in shareholding groups. Too much reliance on survey or other structured interviews could have constrained in-depth inquiries in the sense that informants may not answer the questions in their own freely chosen, open ended way.

To gain a grounded appraisal of SSG practices in the state-owned insurer, face-to-face onsite interviews with elite managers and officers were conducted between June and September 2009, as well as between August and October 2010. Chinese society was shaped for a long time by Confucianism and then by Communist ideology where structure and hierarchy have been very important. Organizational members – whether from government agencies and business entities – are expected to observe rank and show deference and humility to their superiors. By so doing, they tend to raise their own position in the view of others rather than lower it. For these reasons, a top-down interview strategy was employed, one which refers to

starting elite interviewees at the top and then working down the formal hierarchy. The researcher's own relational connection with the managers offered an established social network for identifying and contacting potential elite informants. While finding an initial correspondent can be difficult in initiating the "referral chain", cooperation from some board members and senior executives was first achieved by building contact with the board's own secretary. Other senior staffs were thought more likely to participate if they could see their referrals had been approved beforehand. Such a snowball sampling approach was found to be economical and effective in enabling real-time access to other organizational actors.

The background to each research topic was investigated before individual interviews were conducted. More importantly, demonstrable expertise on such topics proved an effective way to gain the confidence of higher status informants (Arksey and Knight, 1999, p. 123). As Arksey and Knight (p. 123) recommend, drawing on the researcher's own social-cultural capital helps generate "greater symmetry in the interviewer-interviewee relationship" and establishes more "trust and rapport" with informants. For example, it was not possible for the interviewer's knowledge to be checked out by the informant when interviews began. If the researcher appeared unfamiliar with the issues involved, and therefore unable to hold an informed discussion, the efficacy of interviewing would have been reduced, as informants could have been less willing to respond.

Interviews were normally conducted on each week's Thursday and Friday, since interviewees' schedules were found to be less full as weekends approached. Each interview was scheduled to last for no more than three hours, and indeed averaged about two and half hours, not including conversational "small talk" prior to dinner. It relied on a number of open-ended enquiries where the interview questions could be modified or expanded to other areas contingent upon informants' interests, profession, and educational background. This type of questioning allowed flexibility regarding what additional questions could be asked, or what sensitive topics should be avoided as the session progressed. The distinctiveness of such open-ended questioning can be interpreted in three respects:

- Most interviewees were departmental decision-makers in China Life's headquarters and also senior officers in regulatory agencies. Such Chinese social elites are highly esteemed and accustomed to having others defer to them. They are also used to being respectfully asked what they think and also conversing freely and at length without undue interruption (Arksey and Knight, 1999, p. 124). They often resist any structured interview where they

feel unduly constrained by pre-prepared interview schedules. As Arksey and Knight (p. 124) put it, “they do not want to be pigeon-holed into particular categories, or become part of some statistical aggregates”.

- Open-ended questions are suitable for discussing topics of interest in more depth (Berry, 2002). Researchers often encounter situations where interviewees become evidently terse, cautious, and unsure about what, and how much detail, should be disclosed. This was evident with sensitive topics such as business irregularities and personnel control by party committees. When this happened, an interviewee might provide an answer lacking the information needed. It was then important to ask a follow-up question, since silence created tension, disrupting how the interview flowed.
- Open-ended questioning creates space for unanticipated topics which could reveal findings which might not surfaced under structured interview conditions. Thus the researcher can explore the scheduled topics while adding new variations as the interview progressed. As Berry (2002, p. 681) put it, “this kind of branching can be very rewarding and is one of the main benefits of open-ended questioning”. In particular, open-ended questions can allow corporate elites to disclose what they - not the researcher - consider most relevant.

Such flexibility can come at the cost of reduced validity and reliability. A risky but potentially valuable type of interview technique requires the interviewer to decide whether the informants are offering “distracting digression” or “an interesting avenue to pursue” (Berry, 2002). For example, during a trip to Beijing, a former board secretary actively involved in the defence of class action lawsuit was interviewed. He responded to the question about the role of the Shareholding Group with a two-hour review of the group restructuring (*jituan chongzu* in Chinese) process prior to China Life’s overseas IPO. He repeatedly denounced the previous remuneration scheme for encouraging misleading and exploitative sales practices. However, he also referred to changes in monetary policy since the mid-1990s and the impact of lowered interest rates which significantly reduced investment returns. He proceeded to review the pervasive non-performing asset problem in China Life in a way which would have been inappropriate to interrupt in order to return to other scheduled questions.

4.4.2 Archival Data

Extensive use was made of archival data to prepare interview questions, prompt interviewees to elaborate, or corroborate other interview findings. The usefulness of such data was

therefore not limited to verifying the correct spellings of names and titles of the informants and departments that would be included. Systematic searches for relevant documents and other archival data were conducted both prior to and after each fieldwork visit. As an overseas listed company in the public spotlight, there is an obligation to provide accurate and reliable Company information, since records are also referred to by institutional investors and stock exchanges for investment and regulatory purposes.

First, the archival data, both numerical and non-numerical, afforded more time for in-depth inquiries within each interview's limited time span. Second, although some archival data were not sufficiently detailed, other data – such as media reports and internal organizational records – complemented further exploration and probing, serving as dialoguing media for issues brought up during unanticipated in-depth discussions. For example, the business irregularities in China Life revealed by the National Audit Office of PRC allowed the researcher to probe issues concerning internal control and governmental supervision. Corporate managers themselves introduced topics which might not have been discussed otherwise. Finally, documentation and archival data were used to corroborate other data sources (Yin, 2011). While this helped limit the difficulties associated with possible interviewees' selective retrospective biases, it also recreated the informants' "temporal and contextual frame of reference," which can otherwise benefit case study research (Gibbert, 2004, p. 671; see also Gibbert and Probst, 2011).

4.5 Qualitative Data Analysis and Generalization

The phase of data analysis requires further elucidation (Rubin and Rubin, 1995). It can be challenging due to the intangible nature of regulatory implementation and CG practices, which poses significant difficulties for coding and analysis purposes, and questions currently available qualitative software programmes. This section presents set procedures for the analysis of interview data that parallel Alexiadou's (2001) accommodated to the particular type and content of research questions adopted. The first step concerns the integration and analysis of individual interviews, the second the generalization of detailed research findings (see also Potter and Wetherell, 1995; Wetherell et al., 2001). The focus is on how corporate managers and regulators sought to make sense of change, and the types of discourse they employ for that purpose.

4.5.1 Analysing Individual Interview Transcripts

The aim of this stage is to summarize the interview records of individual informants in order to capture the essential meanings and characteristics of what they disclose (Alexiadou, 2001). The 31 multi-level elite interviews and the secondary data gained from various archival records produced rich data in either Chinese or English. Rather than being converted into processed data or translated into a unified language before analysis, all narrative data were coded and interpreted in their native languages to maintain their original meanings. The following procedures demonstrate how individual accounts have been constructed in order to encapsulate such rich data.

Stage 1 This involved reading and re-reading interview scripts together with archival records in order to develop a sense of the whole for each interview. The time immediately following the interview was usually the most appropriate to conduct revisions and complete fast-written transcripts. At times this required more detachment from the fieldwork to identify other aspects needing to be explored or/and classified.

Stage 2 This involved identifying those words or phrases most relevant to research topics. It highlighted the part of the text that was considered to bear “weight” of the meaning, while putting aside but not deleting what was deemed to further amplify an existing argument, or introduce another, possibly ancillary topic. Since certain judgments were likely to be premature at this early stage, the whole transcript would then be re-examined so that the data initially excluded as “insignificant” could be duly reconsidered. At this point, words and phrases deemed marginal to “the participants’ experiences, and perceptions, as well as to the understanding of the context within which they work” were put into parenthesis (Alexiadou, 2001).

Stage 3 This represented a preliminary attempt to code data by “encapsulating the meaning in the form of a word or a phrase that represents a theme” (Alexiadou, 2001, p. 58). The main theme was abstracted from the conversation transcripts by asking the question “what does this part of conversation tell me about the research topic under discussion?” The example below exemplifies the abstracting process.

“...In our regional audit centre, we are expected to investigate both the financial and business irregularities. Conventionally, we have to conduct field inspection to find out the malpractices and loopholes. According to the Codes for Internal Audit Staff, we are required

to examine the business financial records of those branch companies, from provincial level to country level... ”(IN35, 2010).

In this paragraph, the theme has been depicted as “responsibility”, which reflected the researcher’s definition of the informant’s implicit assumptions guiding inspection and audit activities in branch businesses. The theme can be directly quoted from an informant’s talk or, in most of cases, represented the researcher’s conceptual definition of what has been read from the data.

Stage 4 After initially identifying themes, the ‘data bits’ related to similar research topics would be synthesised or clustered together into the same categories. This has been termed “second order constructs” where the researcher intends to integrate or separate the different interview contents or paragraphs into mutually exclusive and clearly defined categories while recognising the links between them (Alexiadou, 2001). Instead of evaluating the status of various categories, at this stage the focus shifts towards defining themes as precisely as possible, and trying to ensure that different categories, including subcategories, are distinct from each other. The requirement of mutual exclusiveness stipulates that unclear boundaries between themes are best avoided to limit possible overlaps of meaning between different “data bits”. The following criteria were adopted to categorize different ‘data bits’: if the paragraphs refer to a research phenomenon that is encapsulated under a particular theme, but at the same time serves as the illustrative or explanatory for another broader theme, such paragraphs will be clustered under the latter.

Stage 5 This meant linking different themes disclosed by informants. Such a sense-making ordering of data entails the unravelling of different themes. For Alexiadou (2001) and Charmaz (2006), the different 'data bits' clustered under respective themes often represent different levels of meanings even for the same informant, so that they differ in importance and serve different purposes within the whole conversation. Thus, the researcher should be concerned with “how do people coordinate with their talk” (Wetherell et al., 2001, p. 5). Using the same example, when a regional audit centre manager was asked “what are the main functions of the regional auditing centre”, the answer illustrated certain aspects of the centre’s main responsibilities. While these aspects were used as yardsticks for assessing the extent to which the centre fulfilled its duties, the theme of “responsibility” as a whole served as the basis from which further discussions were derived:

- It underpinned his appreciation of the audit committee's role and its associated departments regarding corporate governance;
- It structured his further appraisal regarding the formal and informal accountability of internal audit in China Life;
- It precluded discussion of the paramount but undisclosed Part influence in such governance practices.

Stage 6 Informants' accounts could be inconsistent or contradictory. For Potter and Wetherel (1995, p. 88), “we do not expect individuals to be consistent in their discourse – indeed, it would be very surprising if they were. Variation of this kind was expected, as “people perform different actions with their talk ... as they construct locally coherent versions of the social and moral world”. These internal inconsistencies and contradictions could usefully expand upon particular themes when they indicated their different meanings or unexplored aspects.

Stage 7 While others focus upon the character and structure of individual themes, this stage attempted to establish links between different themes by interrogating the data from the research perspective. Alexiadou (2001, p. 62) noted that it reflects “the specific purpose of the study as well as some of the principles of social constructivism”. In this way, similarities, patterns, contradictions, inconsistencies, and different statuses of data bits were sought.

Stage 8 The links established above helped to construct a summary account for each informant. By depicting the essence for each informant, these summaries provided an overview of individual informants' position along with contextual information which could enable further inferences to be constructed.

4.5.2 Generalizing Individual Experiences

The second step of qualitative data analysis sought to synthesize individual experiences to enable both “naturalistic and theoretical generalizations” (Alexiadou, 2001). As to the former, the researcher sought to draw conclusions with respect to the changes which informants and the company reported, so as to make more informed judgements about how these findings might apply in other contexts, i.e. Chinese state controlled corporations. The different socio-economic contexts this crossed (i.e. domestic vs. overseas and pre-reform vs. reform) gave confidence to the detailed findings (Milesa and Huberman, 1984; Alexiadou, 2001). At the same time claims and interpretations of the findings were set against path-

generation theory and other political-economic perspectives. This meant drawing theoretical inferences on the basis of the emerging findings related to the transformative dynamics of corporate governance institutions using the following procedures:

Stage 1 Based on the summaries above, statements about individual participants were formulated to encapsulate their thinking and experience about specific aspects of the research questions posed. Such statements often varied, reflecting their varying roles, and differing regard for the changes concerned. For example, statements concerning senior managers mostly appertained to them, and not the entire management hierarchy. For validation purposes, detailed statements were set against the summary accounts made before, and confirmed or re-formulated accordingly.

Stage 2 Statements made in the last stage were clustered according to their point of reference, and encapsulated into given research inferences. While some statements would appear applicable in particular contexts, others underscored more than one thematic area. In that case, the order of data was constructed according to structure of the final report where detailed research findings were presented.

Stage 3 It was here that meta-inferences were drawn and included in the larger conclusion. In an embedded research design, inference integration relates primarily to the timing of embedding (Creswell and Clark, 2007; Creswell and Tashakkori, 2009; Carmeron, 2009). While the inferences derived from quantitative analysis answered specific research questions regarding how international investors judged SOEs' governance practices, the follow-up case study helped generate further insights via detailed firm-level investigation.

4.5.3 Follow-up Reviews

Upon the completion of data analysis, summary reports in native languages were sent to key informants for further feedback. This tested whether the quotations used were sufficiently accurate and whether further insight could be provided (Gubrium and Holstein, 2002). Succinct summaries which captured the essence of interviews were particularly desirable, since most elite interviewees disliked over-detailed documentation. Moreover, senior corporate managers and other government officials were cautious about written communication. Sending feedback to them was a sign of respect and courtesy which proved useful for sustaining long-term commitment for future research purposes.

Since data analysis and report writing lasted over twelve months, informants did not necessarily recall all that they said before. While further valuable confirmation and comment were received from 8 informants, most did not offer further responses. Table 4.3 depicts the fieldwork procedures adopted over this period:

Table 4.3 Field Work Timetable

Time	Field Work Content
April and May 2009	<ul style="list-style-type: none"> Identifying the main research topics; Gathering background information regarding the selected company and its business sector.
June 2009	<p>First Field Trip to Beijing and Guangzhou</p> <ul style="list-style-type: none"> Preliminary contacts with the initial key informants; Gathering information about the potential elite interviews; Expanding personal connection with other elite interviewees via the initial key informants.
July and August 2009	<ul style="list-style-type: none"> Designing research questions Initiating the first stage of data collection via 12 elite interviews; Reviewing and analysing the first phase empirical data.
June and July 2010	<p>Second Field Trip to Beijing, Shenyang, Shanghai, and Shenzhen</p> <ul style="list-style-type: none"> Undertaking 15 elite interviews with corporate managers, ranging from board members to branch managers; Negotiating access to government officers via corporate elites; Gathering archival records as part of data triangulation.
August and September 2010	<ul style="list-style-type: none"> Reviewing and analysing the first phase empirical data; Identifying and consolidating neglected research topics; Designing further interview questions.
March 2011	<p>Third Field Trip to Beijing, Guangzhou, and Shenzhen</p> <ul style="list-style-type: none"> Undertaking interviews with the rest of the elite interviewees; Revisiting key elite informants and discussing unexplored research topics; Analysing the third phase empirical data.
June 2011 and March 2012	<ul style="list-style-type: none"> Consolidating and comparing all the empirical and secondary data; Consolidating findings from different analysis; Summarizing research findings and sending the preliminary reports selected informants; Modifying reports according to feedback and integrating them.

4.6 Validating Procedures

As the research strategy was qualitative-driven, the focus of validation was naturally placed onto cross-checking the qualitative case study findings. As Jocher (1928) noted, the validity and reliability problems of case studies research can be open to question.

“It can be seen how carefully all evidence must be weighted, tested, and sifted to eliminate fictions and false statements, and as far as possible, rationalizations. It is hardly conceivable that the case study can ever be made wholly objective, for in the very nature of it is inherent a certain subjectivity, not only on the part of those from whom the data are obtained but also in the interpretations of the research specialists” (Jocher, 1928, p. 205).

Although a variety of ex post checks have been suggested, the context-sensitive and interactive nature suggests that there are no infallible rules for establishing the validity of case study research (Miles and Huberman, 1994). As noted by Kvale (1996, p. 242), validation should not be limited merely to the final verification or quality control of research findings; it essentially refers to a dynamic process “built into the research process with continual checks on the credibility, plausibility, and trustworthiness of the findings”. The validating approaches here adopted included: defining the scope and boundaries of the research topic while checking the representativeness of elite interviewees in the research design phase, using multiple sources of evidence, offering guarantee of anonymity to key informants, checking rival explanations and employing a context-aware approach in the data collection phase, as well as seeking feedback from key informants and comparing the evidence with the extant literature in the data analysis phase. These tactics were incorporated into each research stage to address issues of conformability, credibility, transferability, and dependability (Riege, 2003). Key tactics are discussed in detail below.

First, data and methodological triangulation can remedy the potential weakness of case study in constructing validity, since it increases “the credence in the interpretation” and demonstrates “the commonality of an assertion” (Stake, 1995, p. 112; Yin, 2003, p. 92). With triangulation, different data sets provide *supplementary* and *complementary* information. For example, the researcher sought to link informants’ verbal expression to their behaviours through field observation while comparing arguments and interpretations from different and regulatory managerial positions along the governance hierarchy in order to generate “a spiral effect”. The latter refers to an interpretative process in which each set of data, when combined with others, displayed dynamic “interconnectedness” (Caracelli and Greene, 1993). In this way, research findings and conclusions derived from the convergence of multiple sources of evidence can be made more convincing and accurate; the reconciliation of different types of data led to a synthesis which enriched understanding.

Second, rather than relying solely on a theoretical framework, the tested hypotheses and interview questions were also derived from the preliminary research on China's corporate governance reform. A nondirective questioning style can alleviate the problem of "observer bias" or "observer-cased-effects" so that interviewees were not unduly influenced by pre-conceived arguments. Indeed, during this fieldwork, most informants did not ask how the researcher regarded particular governance practices during interviews, though this could surface after. Many emphasized that their answers were based on their own judgments and experience. In this way, the conceptualization of corporate governance dynamics itself emerged 'live' and on-site.

Third, to encourage more openness from corporate elites and government officers, anonymity and confidentiality were guaranteed so that the interviewees would not feel constrained by issues that were politically sensitive and conceived as threatening. Moreover, interviews were often conducted outside office buildings, usually in restaurants outside office hours. This proved essential to ease any tension with informants from the very beginning of interviews and thus overcome any "cover up" in the office site.⁶ It also provided an opportunity to establish rapport with the informants. In a highly status-oriented culture, an invitation to dinner can be related to the need for elite interviewees to maintain positive face – to feel respected by those who are listening to them – and thus serves as a bonding ritual and strategy for narrowing any interpersonal distance between researcher and informants (Bogdan and Biklen, 1982). Moreover, the question-embedding strategy enabled the researcher to lead up to the key questions via other, less threatening ones (Arksey and Knight, 1999, p. 111). For example, questions regarding the decision-making power of party committees were not posed at the start because they could induce unease and reduce cooperation. To gain more chance of being answered, questions were "hidden" or "embedded" in the larger set regarding certain practices.

Fourth, unlike structured questionnaires in survey interviews, participants' accounts via opened-ended questions were contextualized in order to enhance the richness of data and minimize interpretive bias (Mason, 2006). Before fieldwork began, data regarding the analytical units and key informants was collected and reviewed. This helped create a context of "conversational intimacy" in which the interviewer and informants could "share information or give validation just as two other human beings might do" (Corbin and Morse,

⁶ For example, attention from other colleagues would generate a constraining effect on elite informants.

2003). As with a good fiction, the narration usually starts with background information about the subject's own life experience which gradually leads up to the event of interest. This helped researchers and interviewees become easily "immersed in the unfolding drama of the story" (Cooper and Burnet, 2006). Such enriched understanding could result in more interactive interviews which involved not only the asking of questions but also better recording and documenting of informant responses. In this way, notes about the interview process, and verbal and non-verbal expressions from informants were written down immediately, during or after the interview and used to contextualize participants' accounts.

Fifth, the cooperative style employed addressed the problem of "power asymmetry" between interviewer and elite interviewees (Welch et al., 2002). Researchers conducting elite interviews can become "supplicants" so humbly grateful to obtain an interview opportunity that they are reluctant to ask more demanding or critical questions (Cochrane, 1998; Macdonald and Hellgren, 2004). Researchers may also display a form of "hostage syndrome" in which they suspend their clarifying questioning in the face of elites' display of hierarchical power and social status. Thus, interviewers may risk "overestimating the importance of what elites have to say, assuming, for example, that they necessarily know more and better what is going on in an organization" (Ostrander, 1993, p. 19; see, also, Macdonald and Hellgren, 2004; Welch et al., 2002). Here this research contingently sought to develop participation with elite informants from the very beginning. Certain senior corporate managers and government officers with particular academic backgrounds sought to use the researcher as a "facilitator of their own thinking and a sounding board of ideas", since they lacked time for academic study (Welch et al., 2002, p. 625). They could also tend to be more introspective, thoughtful and have an open mindset towards interviews than others with different backgrounds. On occasion some revealed more about themselves when expressing their thoughts and feelings, at the same time seeking validation or recommendation. Such an interviewing strategy has created "a space for intellectual dialogue and reflection" and thus differs in nature from the managers' and officers' day-to-day routine of meetings (Welch et al., 2002).

Finally, in a single-case study, measures for ensuring the generalizability penetrate through all research stages, in contrast to quantitative research where such measures rely upon large sample sizes. Since this study focuses on corporate governance reform in China's state sector, these measures sought to identify all those attributes that are common between the selected

case and the population of interests (Kennedy, 1979). These common attributes enable the findings to be applicable beyond the immediate case study. As previously observed, the selected company is particularly representative, and thus exemplifies “a stable, cross-case relationship” with the population under study (Seawright and Gerring, 2008). At the data collection stage, multiple evidence sources also increased the breadth of information collected regarding the selected case, and thus assisted understanding of the full circumstances surrounding the target corporate governance system (Kennedy, 1979). It is important to bear in mind that “the investigator’s goal is to expand and generalize theories (analytical generalization) and not to enumerate frequencies (statistical generalization)” (Yin, 2003, p. 10).

4.7 Summary

This chapter has considered the rationale underlying the chosen mixed-method strategy and presented the measures taken to address certain specific operational issues. It has examined the value of the mixed-method design often associated with integrative data analysis. The detailed design of both the case study and statistical analysis, including sample selection, data collection methods, analytical models, and validating instruments, has been discussed and assessed in detail. Although mixed-method research can incorporate the strengths of different methodologies, it is still important to select methods or approaches “with respect to their underlying research questions, rather than with regards to some preconceived biases about which methods should have hegemony in social science research” (Johnson and Onwuegbuzie, 2006, p. 23). In other words, the choice of a mixed-methods research should be driven by the nature of research questions rather than the instrumental value and status of different methods.

The qualitative single case study – a combination of elite interview, participant observation, and archival reviews – revealed a number of context-specific, hard-to-measure and difficult-to-articulate characteristics of corporate governance (Mason, 2006). This includes the social embeddedness of its development, firm and industry-specific barriers during implementation, and the corresponding manoeuvrings of local actors to overcome certain obstacles. It has shown the important contribution made by elite interviews, supplemented by archival data, which enabled more elaborate understandings of a little-known and hard-to-explore research problem. As noted by Mason (2006), case studies have both the explanatory and exploratory edge, precisely because they are concerned with more in-depth investigation than statistical

measurement or causation. It highlights the role of the researcher as “the carrier and interpreter of the lived meaning of the key people in the study” (Pettigrew, 2013, p. 124). However, such research also bears certain limitations. Since it was conducted mainly by the author, a single researcher observing elite interviewees within a limited number of settings, and despite the validating measures taken, it necessarily relies on his communication skills and interpretive ability. Systematic bias therefore still occurred. Although this problem can be addressed by single-case replications (Yin, 2003, p. 36), the nature of this study made this unduly difficult.

Chapter 5

Path-Based Explanations for China's State Sector Governance

5.1 Introduction

This chapter uses a path-based approach to illuminate the transformative dynamics of China's state sector governance (SSG). It seeks to answer the following questions: to what extent and how has Chinese SSG been changed? In more theoretical terms, does the current system effectively perpetuate past central planning, given continued state influence? Or have accumulated incremental reforms already led to a more distinct, though still state-centric model? If so, who are the most proactive change agents? What constitute the major obstacles to reform? Which strategies have they employed to achieve it? The chapter will explore these questions and, in particular, use path-generation arguments in examining state sector reform in action. It suggests that path-generation theory can explain observed SSG reforms once due attention is paid to the surrounding political-economic context and leading social actors' interaction.

The chapter proceeds as follows. Section 5.2 introduces an actor-based analytical framework which identifies the critical stakeholder dimensions and associated institutional domains in China's SSG system. Sections 5.3-5.6 present four parallel narrative accounts of the transformative process in individual domains. It demonstrates how changes in an individual domain, elsewhere taken to be inconsequential or passively *adaptive*, may also be recognized as a part of a broader systematic transformation once other changes are also taken into consideration (Streeck, 2009). Section 5.7 tests the findings derived from preceding narrative account with simple statistical regression about how international investors judge or perceive prevailing SSG practices, which foreshadows the direction of future reform. The last section summarizes the relevant research findings and future research priorities.

5.2 An Actor-Based Analytical Framework

Empirical inquiries here require an analytical framework regarding the 'embeddedness' of China's SSG system. The prevailing finance-accounting literature has elsewhere been criticized for its 'thin' view of the institutional environment actually influencing real governance practices (see also Heidenreich, 2012; Stroz et al., 2013). Consequently, the

actual interaction among various actors has not been fully specified, and the coherence of the national SSG system unduly exaggerated (Aguilera and Jackson, 2003). While political economists have insisted that “institution matters”, they may risk applying an over-socialized perspective which constitutes institutional effects too broadly for more precise empirical determination. To bridge the gap between under and over socialization Aoki (2001, p. 18) deemed it necessary to “make explicit the mechanisms of interdependencies among institutions across domains in each economy”. Aguilera and Jackson developed an actor-centred institutional model to capture the most critical institutional domains associated with each stakeholder group. In their view, although institutional environment is not the only determining factor, it nevertheless shapes how the interests of various stakeholders are defined and represented. The resultant institutional arrangements in turn generate different types of conflict and/or coalitions for further development.¹

Figure 5.1 An Actor-Centred Analytical Framework

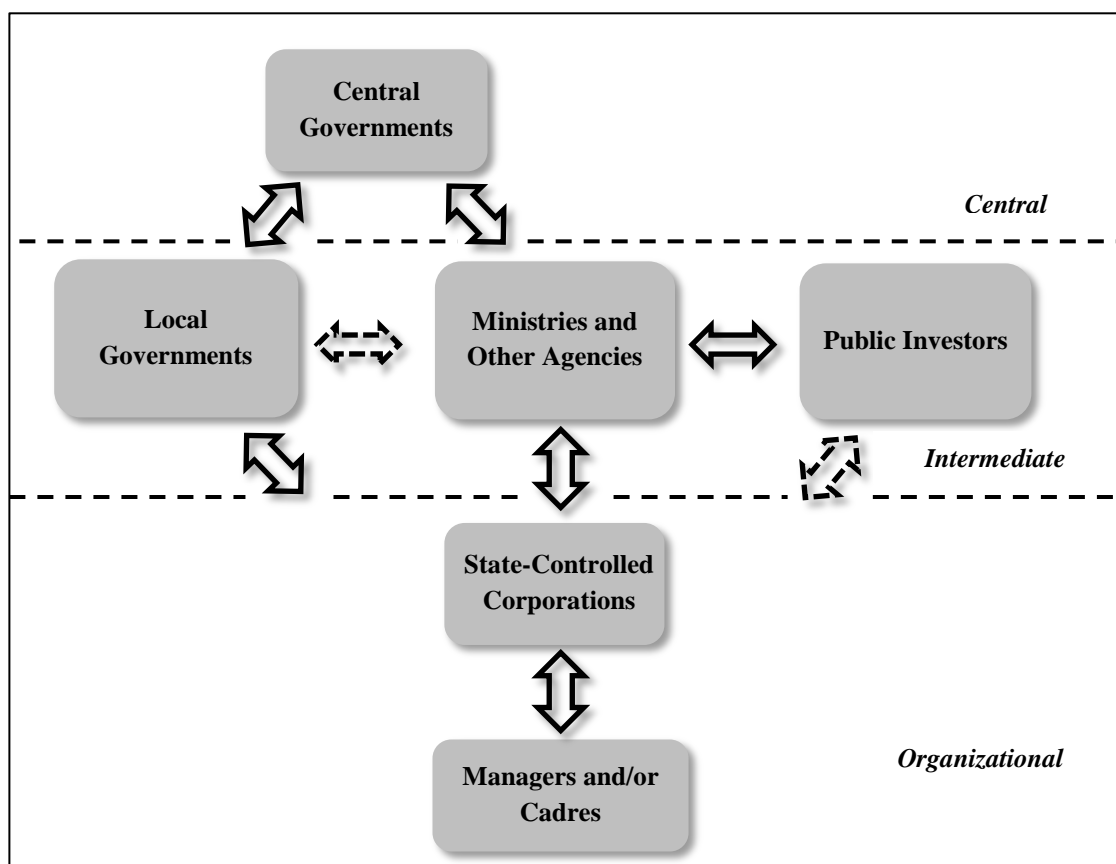


Figure 5.1 depicts an actor-centred analytical model which includes the critical stakeholders with the most direct relevance to SSG practices. The framework seeks to encompass

¹ As Stark and Nee (1989) pointed out, the great uncertainty of changing corporate institutions forces the reform leadership to form a political coalition in order to keep enterprise reform on the agenda.

stakeholders in terms of authority, finance and management, drawing upon the existing reform directed literature (e.g. Shirk, 1993; Naughton, 1996; Qian, 1996; Tenev et al., 2002; Wu, 2005; Pei, 2009; Jung, 2011; Tricker, 2012). These key players are further categorized into central, intermediate and organizational levels in order to reflect different governance hierarchies. In this way, the associated institutional domains can be further identified and analysed. Where the prevailing finance-accounting literature may view the government as if a monolithic stakeholder, certain studies have already suggested that the political interests and reform imperatives of central government, ministries and local authorities can each differ significantly, calling for much more fine-grained analysis (e.g. Oi, 1992; Blanchard and Shleifer, 2000). Following this convention, Chinese SSG stakeholders have been represented as existing in central government, individual ministries and other agencies, as well as local governments. Although different stakeholder groups and institutional domains are analytically separable, they can be closely interwoven (see Naughton, 2006; 2008). Thus the double-ended arrows with solid lines indicate strong and frequent interplay between two groups, while the arrows with broken lines suggest that the parties' mutual influences are rather limited.

Underpinning this framework is the idea that institutions are influencing the roles of stakeholders toward the state-owned enterprises (SOEs) and/or state-controlled corporations (SCCs) without necessarily determining further outcomes (Aoki, 2001; Aguilera and Jackson, 2003). Institutions shape the political process of how participants' interests and responsibilities are defined and represented with respect to the SCCs. Strategic interactions among stakeholder groups generate different types of issues which in turn impact upon institutions in a self-sustaining manner (Aguilera and Jackson, 2003). This synthetic model aims to complement the under-socialized limitations of the conventional neoclassical arguments by highlighting the institutional embeddedness of the SSG system under investigation. On this basis it helps to investigate and explain the distinctive dynamics of Chinese enterprise reform by specifying interplays among stakeholders interacting with the institutional environment. It is elsewhere argued that due SSG requires balancing the different interests and power of diverse stakeholder groups (Mallin, 2011).

5.3 Central Government and SOEs

According to China's Constitution, central government is the ultimate owner and administrator of the state sector on behalf of the Chinese people. Meanwhile, as the key

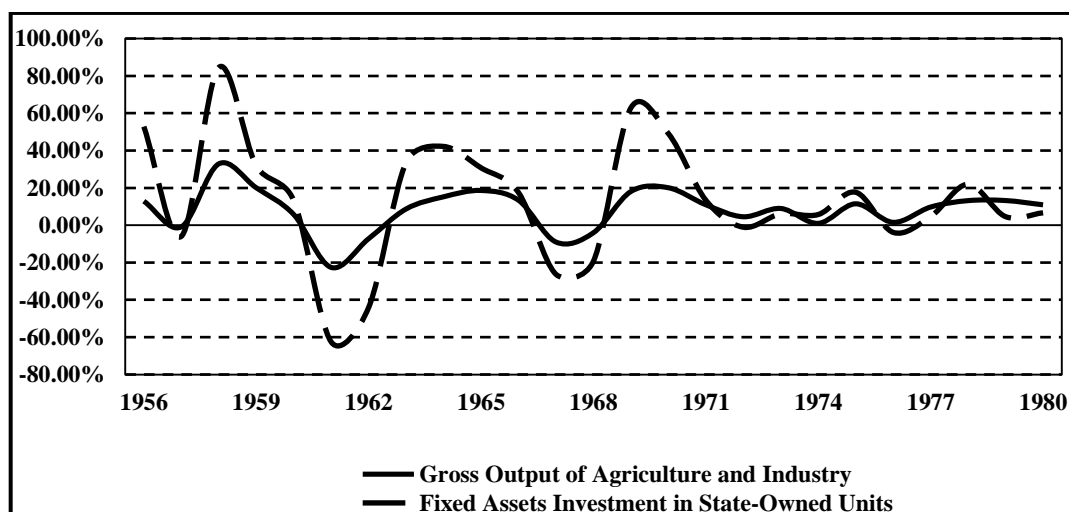
institution for China's state-led developmental strategy, it has also played multiple roles as the planner, executor, monitor and coordinator of reform. The state sector's restructuring has avoided a dramatic "Big Bang" approach and instead pursued incremental institutional reforms. For systematic reform without outright privatization changes in the core coordinating institutions are potentially critical (Jung, 2011). Changes in the broader social-economic contexts significantly redefine central government's relation to the state sector as indicated in the renewed focus upon different stages of reform.

Central planning has its origins in a State Syndicate model in which several functional commissions – notably the State Planning Commission (SPC) and State Economic Commission (SEC) – once assumed the leading role in directing and administering the state sector. As the power of drafting and implementing specific operational plans was delegated to line ministries, functional bureaus and regional governments, SOEs – known as state-run units (SRUs) (*guoying danwei* in Chinese) of that time – were essentially the grass-root productive units within the ruling administrative fiat. In that model, the various economic and productive parameters that determined the size of residual income such as wage and taxation levels were arbitrarily determined by the government itself. State ownership rights had been highly segmented or fragmented since the very beginning (Wu, 2005, p. 141). The complexity of different and even conflicting directives across various spheres almost made it impossible for central government to craft one clear developmental strategy. Nevertheless, with its extensive administrative infrastructure, the system claimed some superiority in mobilizing resources across China's vast territory. This was of vital importance for the new-born regime of the "people's democratic dictatorship" which formally sought to achieve maximum growth of the country's industrial and military capacity over a relatively short time (Shirk, 1993, p. 25). In particular, the urgent task of reconstructing the national economy, following decades of foreign invasion and civil war was combined with the military threat from the West and later the former Soviet Union. From 1956 to 1976, the estimated average growth rate of industrial output nevertheless reached 10 per cent per year.

However, the price of maintaining such growth was high. In the chaotic aftermath of the Cultural Revolution, measures designed to restore the deteriorated national economy only achieved limited success. Over the "rehabilitation" period, the central leadership represented by Hua Guofeng and those supporters known as the "Two Whatever" Gang (*liangge fanshi pai* in Chinese), opted for a series of *recentralizing* measures via stronger administrative

discretion. As shown in Figure 5.2, during the centrally-planned era, the annual increase of fixed asset investment in the state sector (13.44 per cent) exceeded the annual growth rate of industrial and agricultural output (8.30 per cent). Ma (1981) observed that the gross output value per every RMB 100 of industrial fixed assets fell by 25.4 per cent over the same period. Based on restored statistical records, Dernberger (1982) estimated that total factor productivity declined at an annual rate of 2.75 per cent from the 1950s to the 1970s. Shirk argued that the Chinese economy was then producing self-consuming growth, i.e. industrial growth was offset by an ever larger portion of industrial investment (see also Hirsztowicz, 1980). Moreover Chinese central planners encountered the same problem with low mass living standards also found among other socialist economies. For Ma, average individual income remained low, although the gross output value of industrial and agricultural production increased by over 800 per cent, and national income by more than 400 per cent between 1952 and 1980. Average grain consumption was less in 1976-1977 than in 1956-1957 (Xue, 1983). Thus China's heavy industrialization was accomplished without really improved living standards.

Figure 5.2 Growth Rate of Fixed Assets Investment in the State Sector (1956-1980)



Source: China Statistical Yearbook 1986

Right across this era, excessive power concentration among central bureaucracies was deemed the primary cause of low efficiency. Over the centrally-planned era, the party state had wrestled with the competing goals of pursuing political and social policies that were consistent with Marxist-Maoist ideology and the more immediate and pragmatic task of improving economic production (Dickson, 2003, p. 7). Although both goals were important for legitimizing the ruling CCP, they required rather different set of strategies that, in

practice, were often potentially counter-productive. Moreover, central government's ability to draft and implement effective economic planning had been overestimated. Policymakers did not realize that efficiency concerns actually arose from rigid administrative planning along with illicit governance mechanisms.² For Naughton (1986), the weaknesses of central planning were clearly demonstrated by soaring inflation and inability to implement long-term development plans for the oil industry.

In this vein, state sector reform had largely focused on readjusting the relationships between central and provincial governments, and thus administrative decentralization had only seemed viable until performance repeatedly deteriorated. In contrast, as administratively directed economic planning required consistency, power decentralization inevitably exacerbated certain problems, and finally ended with recentralization.³ By the late 1970s, these “pendulum” swings between administrative decentralization and recentralization were widely regarded as highly problematic in themselves. The dissolution of the Ten Year Plan in 1978 demonstrated that the rigid State Syndicate Model was so incompatible with economic development that central leadership underwent a legitimation crisis that further divided “reformists” from “conservatives”. This duly enabled Deng Xiaoping – allied with other reform-minded leaders – to discredit hard-line central planners (Shirk, p. 35). For “reformists”, the initial success of the household responsibility system in rural reform then suggested that economic backwardness was rooted excessive administrative overload and lack of independent initiative.

Within central government, advocacy of greater enterprise autonomy had inevitably pitted reformists against opponents, and the State Planning Commission (SPC) and Ministry of Finance (MOF) both saw administrative planning as better for organizing national production (Shirk, 1993, pp. 197-204). Hence, the reformists initiated further enterprise reform with a series of particularistic experiments in order to overcome political risks and resistance (Heilmann, 2011). Such experimentation allowed enterprises to sell their extra output at higher market prices and retain a share of their profits after fulfilling the stipulated production quotas or financial targets (Wu, 2005). In most cases, these experiments were

² Economically, it was impossible for the technically unsophisticated Chinese planners to incorporate so many into a unified central plan, though ministerial command could provide effective nationwide coordination through its integrated top-to-bottom linkages.

³ Xue (1983) noted that “a recurring cycle in which centralization leads to rigidity, rigidity leads to complaints, complaints lead to decentralization, decentralization leads to disorder, and disorder leads back to centralization” (see also Unger, 1987).

complemented with special fiscal and regulatory treatments based on the economic and political conditions of regional governments and enterprises (Oi, 2011; Zeng and Tsai, 2011).⁴ In this way, reformist leadership utilized local experimentation to generate innovative policy options for national policy-making. The selective allocation of these “lucrative” experiments to localities and enterprises helped the reformist leadership to expand the pro-reform constituency consisting of those “fortunate” officials and managers. A brief but painful episode of contraction induced readjustment by orthodox central planners, “by teaching industrial officials the potential benefits offered by the market and by giving them a recovery rationale for demanding more profits and more market freedom”, had ironically actually accelerated reform (Shirk, 1993, p. 219). Although central government initially directed that profit-retention experiments be a small, specially authorized number, the actual number exceeded 6,000 by 1980. These experimental enterprises, albeit constituting less than 20 per cent of all SOEs, contributed 60 per cent of total national output value and 70 per cent of enterprise profits. The SEC took up the cause of experimental success and became the leading bureaucracy for promoting further nationwide enterprise reform. Beginning in 1982, the official goal of SOE reform was to enhance incentives for managers and workers, and thus increase state revenue. Programs based upon power delegation and profit retention subsequently became the mainstream approach throughout the 1980s.

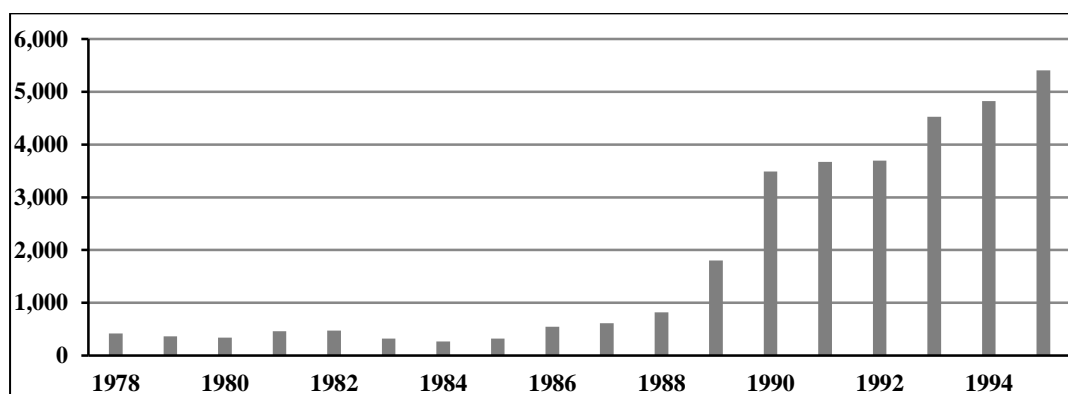
The policy emphasis on expanding managerial autonomy could claim a credible economic rationale. It essentially represented central government’s attempt to change incentives for managers and workers without also making far reaching structural changes. For central government, granting managers and/or cadres part of the residual control improved enterprise incentives, productivity and technological innovation, and thereby promised increased state revenues (Zhao Ziyang’s speech to the Fourth Session of the Fifth national People’s Congress, December 1981, quoted in Shirk 1993). However, its effects were still mixed. Without effective governance mechanisms, expanded managerial autonomy further dissevered state ownership and created more opportunities for insider control, economic corruption and illicit privatization of state assets (MacNally, 2002). Asymmetric power and

⁴ The main purpose of the reform policy was to further expand enterprise autonomy, by which enterprise directors were granted a broad range of rights concerning enterprise operation. These included production, pricing, sales, procurement, foreign trade, investment, disposal of retained profit, mergers and acquisitions, labor, personnel management, wages and remunerations, inter organizations, and finally refusal of the unnegotiated profit remittance to the government (Qian, 1996).

responsibilities encouraged short-term profit maximization, where it was essentially assumed that the state was the ultimate bearer of risk and loss (Chen, 1995; Choe and Yin, 2000).

Both Chinese officials and economists (e.g. Qian, 1996) then admitted that reforms throughout the 1980s had failed to transform SOEs into profit *maximisers*. As shown in Figure 5.3, rising losses since the late 1980s demonstrated that initial enterprise reform had only limited success.⁵ Apart from encountering unprecedented competition from the non-state sector, diminished enterprise profitability could often be attributed to illicit governance mechanisms, especially flawed incentive structures. As state subsidies to loss-making SOEs reached untenable levels, the SRUs – once major revenue sources – were “depleting” the treasury and legitimacy of the party-state in an unsustainable way (You, 2002, p. 173). With a declining revenue base, the central government could not offer the same scale of bailouts. It also made it difficult for SRUs to carry out their full range of social obligations and even regular salary payments. This in turn intensified the need for pension, medical and housing reforms (Saich, 2011). The anxiety of the central leadership was clearly conveyed by Chen Yuan, former PBOC vice governor, who openly asserted that the loss-making state sector was not just a serious economic problem, but also one that could not be neglected politically (Chen, 1991, p. 18).

Figure 5.3 Profit Losses in China's State Sector (RMB Million)



Source: China Statistical Yearbook 1996

⁵ The losses of SOEs in fact increased steadily since the eve of the reform. The first quarter of 1996 even registered RMB 3 billion across the state sector (see Wu, 2005). While more than 27 per cent of the SOEs recorded losses in 1990, this figure rose to 43 per cent in 1995. For example, in 1991, it was estimated that the state had to RMB 254 billion to cover the total loss and unpaid investment loans in the state sector. This amounted to 12.6 per cent of GNP, 62 per cent of the state revenue, 75 per cent of the national wage funds, and more than 45 per cent of the total social capital investment of the same year (see Pei, 2009).

Nevertheless initial enterprise reform claimed some success where it successfully created newly vested interests and thus expanded the constituency for reformist leadership (Naughton, 1996). A decade of power delegation and fiscal decentralization made more local officials and enterprise managers aware of profit motives and the need for institutional innovation. Material incentives were seen as the major means to stimulate extra effort if the socialist principle of ‘to reward each according to his work’ was reapplied (see also Saich, 2011, p. 267). Egalitarianism had been repeatedly challenged as a dangerous notion hindering economic growth and productivity improvement.⁶ With the thriving non-state sector and the collapse of Soviet Communism, central leaders realised that simply stressing technological up-grading and granting managerial autonomy did little to improve the health of SRUs unless the more fundamental reforms were implemented (Saich, 2011). There was a growing consensus that government intervention should be further separated from enterprise management in order to “make sure the owner is present” (*quebao suoyouzhe zaiwei* in Chinese). This required further structural changes in the State-SOE relationship. However, reform measures had not been carried out until the “socialist market economy” was launched during the Third Plenary Session of the 14th Chinese Communist Party Central Committee (CCPCC). Amid such major ideological breakthroughs, central government viewed corporatization as the appropriate strategy for economic development. It advocated the conversion of SOEs into western-type corporate entities predominantly in the form of limited liability companies and joint-stock companies. Corporatization was here intended to address through structural reform the failings of the previous SSG system that were blamed for inefficiency, multiple goals, and absence of an effective ultimate principal (Clarke, 2003). The ultimate intention was to establish a modern enterprise system “with clearly established property rights, well-defined power and responsibility, separation of enterprise from government, and scientific management” (Decisions on Issues regarding the Establishment of a Socialist Market Economy System, 1993; see Tenev and Zhnag, 2002, p. 7). After the promulgation of 1993 Company Law, the State Economic and Trading Commission (SETC) – another incarnation of the former SEC – was established and further empowered to direct and implement corporatisation schemes (Jung, 2011, pp. 121-123). The idea of the modern corporation was then closely linked to what Chinese central policymakers considered to be superior performance (Tam, 2002).

⁶ This can be reflected in Deng Xiaoping’s much-quote phrase “to get rich is glorious” (*zhifu guangrong* in Chinese).

Since the early 1990s, the focal point of the Chinese corporatisation has been the transplantation of the market-based corporate governance (CG) model through a top-down legalistic approach (Tam, 2000). In this vein, newly corporatized SOEs are required to form the statutory and essential corporate governing bodies, including (1) general meeting of shareholders, (2) board of directors (BOD) and the chairman, (3) supervisory board (SB), and (4) chief executive officer (CEO). For Tam (2000), this has gone against the tenet of China's gradualist approach to overall enterprise reform: these highly prescriptive laws and regulations are replicated primarily from the stylised Anglo-American model notionally based upon suitably competitive markets. Consequently, CG is considered by the Chinese policymakers and economists as:

“The organisational structure consists of the owner, board of directors and senior managers. A check and balance relationship is formed within that structure, through which the owner entrusts its capital to the board of directors. The board of directors is the highest level of decision making of the company and thus has the power to appoint, reward and panelise, and dismiss senior managers” (Wu, 1994, p. 185; see also Tam, 2000, p. 53).

As the key element of corporatisation, CG assumed increasing prominence for reform as the party-state tried to “promote enterprise performance and to look after its ownership stakes in various forms” (Tam, 2002, p. 304; see also Nolan, 2007). For some (e.g. Szamosszegi et al., 2011; Lin and Milhaupt, 2013), corporatisation reflected the desire to building modern enterprise institutions more compatible with the competitive market economy. However, for Heilmann (2011, p. 95), the redistributive nature of enterprise reforms encountered “very strong political inertia and oppositions that are inherent in a socialist and post socialist political economy”. In particular, the divestiture of state capital has been politically sensitive considering previous doctrine emphasizing the unchallengeable status of public ownership. Where the rule of law remained rudimentary at best, the country's state sector simply lacked many other supporting institutions for an effective transition towards a market-based model. These include a competitive non-state sector and active markets for corporate control and managerial manpower (Tam, 2000). Most notably, the national social security system had been underdeveloped, and unable to serve as an alternative source of pensions and unemployment insurance for laid-off workers. Central government had feared that this would result in large-scale social unrest which would undermine the legitimacy not only of the reformist leadership itself, but also the CCP as a whole (Jung, 2011). These problems

have been cited by entrenched interests groups in bargaining for continuing soft budget constraints and other preferential treatment.

Given reform inertia, leading policymakers adopted an experimentation-based approach to avoid possible deadlock and also reduce political frictions.⁷ Local officials and enterprise managers become “initiators and active participant in the reform drives”, while ultimate control over revising, terminating and expanding local experiments rested among superiors above (Heilmann, 2011, p. 99). In this way, development came only after experimentation. Many innovative policy instruments constituting the post-1997 breakthrough in SOE reform – including corporatisation and the state asset management system – had been pre-tested in experimental sites (Heilmann, 2011; see also Wu, 2005). Meanwhile, rather than rely solely upon market institutions to corporatize SOEs, central leadership employed potential political and administrative means to orchestrate corporate restructuring in an *ad hoc* manner. In the absence of specified entities representing the state’s ownership rights, central government used administrative streamlining to transform several different line ministries and bureaus into shareholding agencies (Tam, 2000). These agencies, together with the newly established state assets management commissions, constituted the cornerstone of the new state asset management system. Finally, policymakers adopted a dual track approach that allowed seemingly contradictory systems to coexist to without undermining each other. This strategy is evident with regard to the implementation of “grasping the large and relinquishing the small” (*zhuada fangxiao* in Chinese). This policy allowed the party-state – afflicted by mounting fiscal deficits – to divest numerous small and medium-sized, primarily loss-making SOEs in non-core industrial sectors through bankruptcy and outright privatization, diverting economic resources to a smaller population of large firms of “commanding height” where ownership diversification was still rather limited. The coexistence of different ownership types allowed the party-state to publicly adhere to socialist ideology while still adopting new institutions imported from market systems elsewhere (see also Oi, 2011). This marked a clear commitment to a mixed or hybrid SSG system, with the continued dominance of the state ownership and attempts to shift towards state capitalism (Lin and Milhaupt, 2013).

However, such an unsynchronized, piecemeal process of reform also had its costs. For Wu (2005, pp. 158-159) the governance structure of China’s state sector bore “grave institutional

⁷ This differs significantly from the conventional legislation-centered policy process.

defects”, including ever-fragmented ownership rights and more-prevalent insider control. As a coalition building strategy with hard-line opponents, most state asset management commissions and shareholding agencies were actually staffed by incumbent bureaucrats from abolished ministries and administrative bodies. The remaining governmental apparatus thus still influenced major investment and production decision makings, as well as personnel appointments. Corporatisation, combined with the more general decentralisation of state administration, allowed multiple interventions at different levels, although this might have clarified the central and local governments as *de jure* owners (OECD, 2005b). All this further fragmented state ownership rights. At firm level high ownership concentration allowed state-authorized investment agencies persistently influence personnel appointments in the operation of listed business entities. The “leading team” members of the shareholding agencies often assumed a dual-role as both the intermediate principals vested with state authority and the salaried executives entrusted by listed company shareholders. They represented the state shareholder to supervise state assets and motivate themselves as listed companies' executives (Wu, pp. 160-161). This increases the capacity of corporate insiders to abuse and divest state assets (OECD, 2005b). As indicated by corporate corruption and state asset stripping, ever-aggravated insider control left both state and public investors highly vulnerable. In addition to revealed governance problems, pressures from economic globalization, as represented by both the 1998 Asian Financial crisis and China's WTO entry, provided important economic and political imperatives for accelerating reform. For Gallagher (2005), these exogenous events created a powerful rationale for more comprehensive restructuring – building a globally competitive state sector became “a matter of national survival” even if it meant the sacrifice of most non-competent enterprises (Jung, 2011, p. 129). To serve as both the “development stimulator” and “strategic choice maker” required central government to establish better control over the state owned sector (Wettenhall, 1996; Thynne, 1998, p. 246; Chan, 2009).

The establishment of the State Assets Supervision and Administration Commission (SASAC) in 2003 was essentially another institutional embodiment of the central leadership's pursuit of improved SOE competitiveness (Green and Ming, 2005; Naughton, 2006; Chan, 2009). It also reflected the conviction that “full privatisation will take quite some time and that the state will remain active, if not dominant, in a number of sectors and enterprises” (OECD, 2005b, p. 131). Chinese authorities repeatedly affirmed their belief that SOEs can operate better with more effective governance (Mallin, 2011). A ministry-level

agency has a broad mandate from the State Council, including rationalizing resource allocation and ameliorating current governance institutions. According to the 2008 State Council Circular on Institute Establishment (Number 11), SASAC can exercise ownership rights on behalf of the central government, including: (1) preserving and increasing the value of state assets; (2) appointing, removing and remunerating key executives on the basis of performance indicators; (3) supervising enterprise management and enforcing related laws and regulations; and (4) implementing the state asset management budget and securing capital gain on behalf of the state. These stipulated missions imply more direct and integrative control over individual enterprises, according to “the 2007 guiding opinion of carrying forward the regulation of state capital and the reorganization of (non-financial) SOEs”. Despite this, SASAC “should not interfere directly in corporate management and operation” activities but should rather take major decisions on behalf of the state shareholder in the general meetings of shareholders and boards of directors. Thus SASAC’s vision of ownership consolidation clearly involved imposing effective checks-and-balances on corporate management and enhancing the role of boards.

These new functions for SASAC were supported by several other institutional changes (see OECD, 2005b). First, amidst deepening marketization and economic globalization, SASAC followed a strategy of “selection and concentration” which allowed it to discard non-core businesses and focus on building nationally strong and competitive firms around a select few national champions (Oi, 2005; Naughton, 2007; Jung, 2011).⁸ The statist thrust of cultivating global competitiveness can be shown in the announcement by the State Council that state capital would have absolute control over seven strategic industries, including armaments, oil and petrochemicals, civil aviation, power, coal, shipping, and telecommunications. Second, by integrating functions previously performed by several line ministries and commissions, SASAC’s institutional power has been further enhanced. In particular, part of the MOF’s authority over equity and revenue disposal was merged into SASAC, which enabled combined regulatory and ownership functions. Although the MOF retained authority over general capital management budgets, SASAC compiled more detailed budgets for central enterprises under its authority, giving it *de facto* control over actual enterprise revenues. Moreover, it was given greater power to limit management buy-outs among large SOEs, reflecting concern about corruption and ‘insider privatization’. Last, although the CCP

⁸ In 2012 after a series of mergers and consolidation, the number of centrally controlled corporations was reduced to 107 from 196 in 2003 upon SASAC’s establishment.

Central Organization Department retained control over central SOEs' top leaders, SASAC could still appoint and dismiss key managerial staff below vice-ministerial level. Like Temasek, SASAC duly found that China's state sector could move towards "a modern and professionally managed system of public ownership" (Naughton, 2006, p. 8). In this view, managerial compensation should be gradually adapted to include stock options and other links to share prices, aligning managers' incentives more with state owners, without ceding managers undue control over state assets. For Jung (pp. 133), "although the scope of central state direct control might have been narrowed, the efficiency and intensity of state control and monitoring over targeted SOEs have increased".⁹

However, as economic liberalization and enterprise reform has greatly changed the *de facto* distribution of political and economic power between the state and SOEs, ownership consolidation inevitably faced resistance from influential stakeholders including the pivotal corporations and even the government apparatus. In October 2007, the State Council finally approved detailed regulations which authorized SASAC to extract dividends from profitable SOEs. Economic growth has produced hitherto unprecedented returns for large state owned corporations, particularly in semi-protected monopoly sectors. Although considered a desirable move to curb excessive investment and maintain growing public expenditure, SASAC has encountered strong resistance from entrenched interests among large corporations (Shi, 2007). Behind slow implementation lay intense lobbying, as central SOEs argued with their patrons that unremitted profits were necessary to make them "internationally competitive". As a result, the budget system came into effect at least two years behind schedule, and SASAC settled for a lower rate of return than expected. As to the disposal over remitted dividends, other conflicts emerged. For SASAC, remitted profits provided resources for detailed corporate restructuring. Although SASAC reached a preliminary agreement with the MOF in 2004 regarding a unified state assets management budget system, it was only in mid-2006 that more detailed implementation began (Naughton, 2008). The intra-bureaucratic tensions arose from the MOF's reluctance to let SASAC be the first collection and management agency for capital gains. Both parties finally agreed that all the post-tax dividends should first be remitted to the MOF with the corresponding portion then remanded to SASAC.

⁹ Fukuyama (2004) stressed the need to distinguish between the scope of government activities and the strength of government institutions.

The central government's vision of instituting sound CG mechanisms while maximizing state asset value coexists with yet another vision in which state ownership is used to advance national interests (Szamozzsegi and Kyle, 2011). Although the number of central SOEs was reduced by over 30 per cent, their total asset value increased from RMB 7 trillion upon SASAC's establishment in 2003 up to RMB 27 trillion by early 2013. This questioned the "traditional" or "pessimistic" view of Chinese SOEs as "industrial and financial dinosaurs fit only for dismembering or bankruptcy" (Hassard et al., 2010). In this respect, SASAC has arguably secured better state asset values and improved global competitiveness. However, the growth of the non-state sector and widening economic inequality have triggered further debates regarding how much state control and influence is really necessary and beneficial (Naughton, 2006).

Certain economists and officials view any increasingly powerful government bureaucracy as constituting recentralization with mixed (up) outcomes (Mattlin, 2007). Imposing more stringent supervision over ownership transfers and investment can nevertheless bring the problem of state asset stripping and corruption under better control. Experience in the NICs suggests that, by channelling necessary resources into the "dragon-head enterprises" (*longtou qiye* in Chinese), state-led industrial restructuring can further improve performance. However, since the state plays conflicting roles as the drafter and enforcer of regulations, as well as being the controlling shareholder, it can change policy choices whenever necessary (Sun and Tobin, 2005; Shi, 2007). The often repeated phrase of "the state advancing, the private sector retreating" (*guojin mintui* in Chinese) implies resentment against the rising dominance of China's SOEs at private sector expense.¹⁰ Failure to address these issues not only exacerbates public tensions, but further questions the legitimacy of the state's role in economic development. In particular, large SOEs are still required to carry out a wide spectrum of social political objectives ranging from regional poverty reduction to the promotion of foreign policies.¹¹

Summing up, changes in the state-enterprise relationship over the past three decades involved a continuous redefinition of state ownership in policy and practice. Where the

¹⁰ This momentum has been further enhanced after premier Wen Jiabao announced a major stimulus package of RMB 4 trillion (US\$ 570 billion) to sustain the country's economic expansion amidst the financial crisis.

¹¹ On 13th May 2012, the Agricultural bank of China (ABC) signed a cooperative agreement with the Ministry of Agriculture (MOA) to provide no more than RMB 50 billion to support economic development in pastoral areas (People's Daily, 16th May 2012). Meanwhile, a series of overseas investments in Sub-Saharan countries by central SOEs, including railway construction and oil field development, were deemed associated with China's foreign policy for enhancing energy security (Naughton, 2008).

unintended and even self-destructive logic of administrative intervention has led to persistent operational inefficiency and mounting fiscal burdens, the role of central policy makers has been transformed, from the ultimate planner and administrator of socio-economic activities towards the more realistic and effective principal of state assets. Those who see centralized control and pervasive statist intervention being preserved have gone to great lengths to argue that the relationship is still stable at its core. However, with the progressive divestiture of ownership control and erosion of ideological compliance, the emergence of new economic actors, including corporate managers and public investors, in essence renders the corporate landscape increasingly contestable. To reconsolidate fragmented ownership rights, central government seeks more efficient and intensive oversight against entrenched corporate insiders. In particular, performance evaluation for corporate management and/or cadres becomes increasingly market-driven, where the party-state seeks to readapt political control to other socio-economic changes. As the extant SSG system and its practices continue to be challenged, this narrative account suggests that China's SSG reform still relies heavily upon administrative and regulatory coordination. In most cases, the exploitation of existent administrative and political resources, such as fiscal decentralization and administrative restructuring, has enabled reformist leadership to orchestrate enterprise reforms in face of other, constraining factors.

5.4 Ministries, Local Governments and SOEs

In a centrally-planned system, ministries and local governments were economic and political agents which central government employed to design and implement specific plans. As part of the vertically integrated government command chain, they enjoyed considerable autonomy and flexibility in decision making. This dichotomy of authority is referred to as a crisscrossing governance matrix in which the vertical hierarchy of sectoral command (*tiaotiao* in Chinese) coexists with horizontal territorial authority (*kuaikuai* in Chinese). While line ministries were authorized to organize production activities according to specific industrial sectors, local governments could also intervene with reference to the localities they govern. Such 'fragmented authoritarianism' differed strikingly from the more unitary and centralized control found among other socialist economies, while the unitary system of control depicted in the pure Soviet model never materialized in China (Wu 2005; Lieberthal, 1992).

The intersection of vertical and horizontal lines of control furnished the basic institutional structure of SOEs' governance system throughout the centrally planned era. Along the vertical line, ministries held the decision-making power, and directives were issued through their hierarchical chain of command. Ministerial commands dominated regional authorities in terms of supervising large-scale productive and economics activities due to their technical expertise and coordination capabilities (Unger, 1987). This was particularly the case for large-sized SRUs that required nation-wide resource input and well-specified technology. Orthodox central planners generally conceived "Branch Dictate" (*tiaotiao zhunzheng* in Chinese) – a slogan which encapsulated the superiority of ministerial commands – as an appropriate organizational formula for making investment and production decisions which could reduce possible dissent and conflict (Shirk, 1993, p. 95).

Under the "Area Dictate" (*kuaikuai zhuanzheng* in Chinese) system, local governments and party committees had direct authority and responsibility over the SRUs within respective administrative areas. Given the prevalence of small and medium-sized enterprises, "Area Dictate" was arguably better suited to coordinate those industrial projects which required local resource mobilization within an immediate area. Decentralized planning power meant that enterprise production and industrial development policies would be promulgated more in favour of local authorities than other ministerial functionaries – the so-called "reds" rather than the "experts". Politically, a regional party committee was better positioned to initiate mass mobilization and manage political campaigns through its direct command over grass-roots party cells. During the Great Leap Forward (1958) and Cultural Revolution (1966-1976), Mao Zedong adopted a power decentralization strategy with local party officials, to overcome the resistance from orthodox central planning bureaucracies represented by vice Chairman Liu Shaoqi (Shirk, p. 151). The "Area Dictate" model implied that enterprise party committees were judged less rigidly in meeting their gamut of quarterly and monthly quotas, giving them leeway for political study sessions. Local officials and Party secretaries saw this "Area Dictate" facilitating "Politics in Command", while disparaging "Branch Dictate" for mechanically putting "Economics in Command" (Unger, 1987). For Lin (2001) the plethora of pseudo-principals in such a crisscrossing governance structure created further contention among different authorities. Two lines of authorities stood juxtaposed in ways that induced deep-seated institutional clashes, or "struggles between two lines" (*liangtiao luxian douzheng* in Chinese) (Unger, 1987, p. 12). Thus, although unified state ownership was stipulated in the Constitution, actual control and/or authorities could be dissevered vertically

and/or horizontally (Wu, 2005, p. 152).¹² Conflict resolution between these two lines tended to be pushed up to a supra-bureaucratic body – such as the central Politburo and its standing committee – which could coordinate responses with more leverage.

For reformist leadership, ill-defined institutional arrangements helped overcome orthodox central planner resistance. As stated, reformists faced daunting internal challenges from conservative bureaucracies among line ministries and functional commissions. From the early 1980s, central leadership promulgated fiscal decentralization (e.g. incremental contracting, basic proportional sharing and tax-for-profit) intended to alleviate inflation and budgetary deficits. Under the initial profit-contracting scheme, regional governments retained a portion of, or even all, above-quota revenues remitted by local SOEs; they also bore a higher proportion of local public expenditure, including subsidies for local SRUs. The rearrangement of residual control over SRUs was vividly described as “eating in separate kitchens” (*fenzao chifan* in Chinese). The quest for fiscal revenue that formerly flowed into the national treasury gave rise to the deregulation of local markets and non-state investment; it also induced local governments to grant local SRCs greater autonomy for further efficiency improvement. Enlarged fiscal and political power brought reformists into a tacit coalition with the provincial leaders to push reform experimentation forward. Local politicians benefited from revenues generated by reform experiments as well as political resources through national publicity and competitions for preferential treatments (*youhui tiaojian* in Chinese).

Meanwhile, the combination of fiscal decentralization and enterprise profit retention raised doubts about the potential fiscal and political consequences. In the context of budgetary deficit in 1979 and 1980, decentralizing fiscal power to provinces appeared an attractive option for relieving central budgetary strains without surrendering proprietary directives (IN33, 2011). However, under expansionary fiscal and enterprise reform, central ministries’ access to financial resources was further reduced and dispersed, and their financial base appeared to be eroding. Officials from ministries, notably the MOF, became less confident of controlling the state sector. As of 1982, the Finance and Tax Reform Group in the MOF publicly complained that it bore almost two-thirds of total national financial investment with

¹² Such division of authority and responsibility within regional government bureaucracies held various government agencies accountable to certain aspects of SOE management and operation on one hand, on the other hand, allowed them to exercise considerable influence over both productive and non-productive affairs at firm level.

only one-third of total national revenue at its disposal (Ma, 1981). To strike a balance between different ministries and localities, central leadership promulgated a tax-for-profit (*li gai shui* in Chinese) scheme which formalized tax obligations. Reducing negotiability while guaranteeing revenue flows helped reformist leadership gain credibility during the CCP leadership succession in the early 1980s (Wong, 2001).

However, there were serious disincentives about this profit-for-tax scheme, since quotas and tax rates were still arbitrarily determined by the bureaucratic apparatus and enterprise insiders (see Shirk, pp. 245-278). Under agreed rules, financial obligations were still subject to bargaining between local governments and central ministries, and enterprises could still rely on government subsidies to cover losses (Shirk, pp. 250; Wu, 2005). As regional governments often afforded local enterprises generous tax concessions and low-interest lending, they were obliged to employ redundant workers and subsidize social services in return. Using their proprietary fiscal autonomy, local governments could channel their off-budget capital into redundant and inefficient processing plants. Industrial duplication under regional protectionism seriously fragmented economic linkages with further resource wastage, leaving central government with mounting economic problems, including non-performing loans (NPLs), reduced central revenue, and interregional disparities. By not developing clearly defined property relations between the state and managers initial enterprise reform left room for unchecked insider control and bureaucratic interventions (You, 1998, p. 175).

Reform went into brief but painful downturn after Tiananmen Square. Many recentralization schemes faced open opposition from local officials and enterprise managers, and eventually collapsed following the dissolution of the former Soviet Union and Deng's 1992 Southern Tour campaign.¹³ Local governments subsequently actively promoted privatization while changed political-economic conditions impacted upon the political calculus of local economic development decision-making:

- The promulgation of a “socialist market economy” explicitly permitted ownership diversification. This fundamental ideological and paradigmatic shift in developmental thinking significantly reduced the political challenges faced by promoters of privatization.

¹³ The tour challenged the conservative-dominated central leadership and reinstated the economic reform agenda, which further accelerated the process of institutional transformation in the state sector (see Goodman, 1994; Gregory, 2010).

- While the institutional legacy of “*tiaotiao kuaikuai*” implied that local bureaucrats were relatively more immune from traditional ideological constraints, the Party’s cadre evaluation system had become increasingly market-oriented, and local governors promotion prospects became closely linked with economic performance during their tenure.
- Central government had enforced fiscal and monetary recentralization to rationalize central budget management and credit control, and the budget constraint upon local government was significantly hardened (see Lardy 1998).
- Deepening marketization further integrated different national markets. Intensifying market competition made it increasingly difficult to subsidize local state-owned industries through trade barriers (Liu and Garino, 2001; Bai et al., 2004). Meanwhile privatization had been facilitated by private sector growth where it presented “an alternative and ready-made source” for laid-off workers (Oi, 2011, p. 10).
- Emerging patron-client relations between local authorities and the private sector ensured the control benefits for local governors continued after privatization (Boycko et al., 1996; Hellman et al., 2003). Such governors could translate their continued political influence into individual shareholdings and/or other assets (see Cao et al., 2003; Tsai and Zeng, 2011).

Within this environment a new class of local, entrepreneurial officials emerged – officials whose success was increasingly dependent on their ability to mobilize resources and generate revenues rather than on their ideological “correctness” (see Duckett, 2001, 2002; Hillman, 2010). Privatization and deregulation became more likely where changing loss-making industrial sectors – mostly dominated by small-and medium-sized SOEs – might reduce regional potential economic growth (see Qian and Stiglitz, 1996). Reform experiments accelerated after the mid-1990s when central leadership again pushed for fiscal decentralisation and state sector restructuring, which began as early as 1992 in counties such as Yibin, Shunde and Zhucheng. Given control over key factors of local production, local officials gained the power to deploy assets in ways that increased local comparative advantage. For Hillman (2010, p. 4), “the local economy began to grow and revenues began to flow, but in a political system predisposed to rule by man and administrative fiat, opportunities for self-enrichment abounded”. In contrast, local governments’ authority over large SCCs receded into being largely consultative (Tenev et al., 2002). Under “grasping the large and relinquishing the small”, large SCCs and their regional branches, including the

“Four Big” state owned banks, no longer depended upon local governments. The latter often operated loose checks upon enterprise management but did not challenge the ownership right or management control of state authorized shareholding groups (Saich, 2011). Many local politicians regarded restructuring as an opportunity to shed responsibility to central government and raise much-needed capital through privatization (Qian and Stiglitz, 1996).

At the same time, large SOE restructuring appeared less efficient in comparison to administrative decentralization and local privatization experiments (Heilmann, 2011, p. 101). Traditionally these enterprises came under the control of central planners represented by line ministries and various functional commissions. Zhu Rongji, premier from 1998 to 2003, recalled that the proposal to restructure large SOEs and administrative streamlining “received fierce opposition from almost every ministerial leaders” (see Jung, 2011). There was not just an economic division between central bureaucracies but also, with regard to their extensive social functions (including kindergartens, schools, hospitals, accommodations, pension funding and so forth), “were comparable to self-contained municipalities” (Heilmann, 2011, p. 102). Therefore, corporatization and even bankruptcy here posed more difficulties than elsewhere, going far beyond ownership transfer, debt restructuring and liquidation. As noted, political resistance coupled with the absence of complementary institutions led the central policymakers to opt for a partial or incremental approach to overcome reform deadlock (Oi and Han, 2011).

Up to 1997, corporatization of the ministerial apparatus and their subordinate enterprises had been implemented as only “a formalistic exercise” based on re-naming and re-arranging old structures and redistributing staff but without transforming actual operations (Heilmann, p. 102). After 1997, the restructuring of these key industrial sectors often took the form of shareholding where the ministerial controls were preserved via concentrated ownership. Shareholding reform was conducted in a way called “first have sons, and then have fathers” – the parent corporations, as represented by various shareholding agencies and group corporations, were created only after better-performing assets were ‘carved out’ or ‘spun off’ to more financially attractive entities. While the latter would then be listed on stock markets, parent companies often remained purely state-owned. These quasi-administrative bodies still carry non-performing assets, redundant personnel and similar. Thus parent corporations required resources from listed companies and preferential treatment from the central

government to cope with the financial difficulties created by asset spin-off (*zizhan boli* in Chinese).

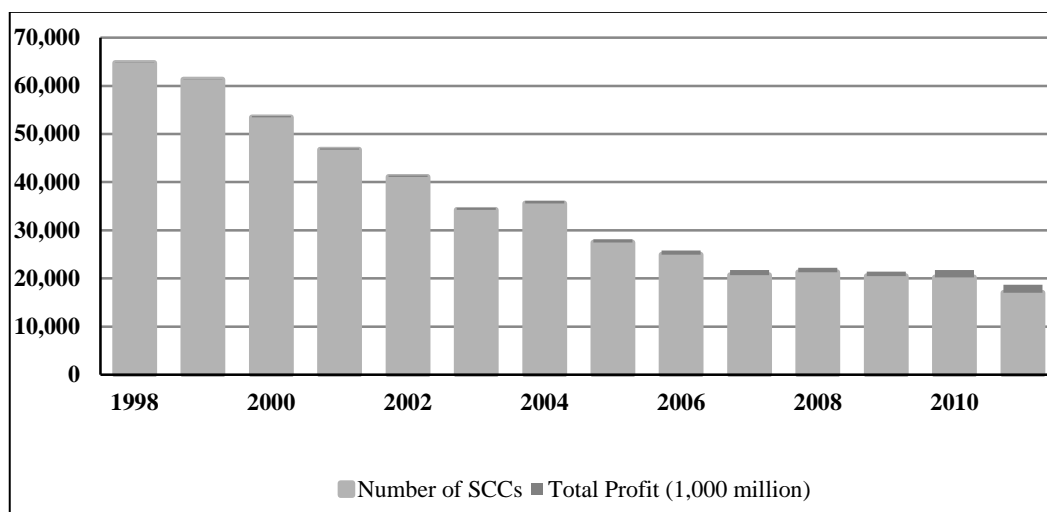
To a certain extent, corporatization through shareholding reduces government intervention in enterprise management. Changes in state ownership status meant that it was no longer so responsible for profits and losses and could not guarantee continued investment (Tenev et al., 2002; Wu, 2005). Such hardened budget constraints reduced central fiscal burdens and made companies, not the state, responsible for performance. However, the preservation of intermediate control agencies also produced “a complex property-right mixture” even within a single enterprise group, and thus principal-agent problems in China are now multiple (Oi and Han, 2011, p. 32; see also OECD, 2005b). While central government acts as the ultimate administrator of state assets, supervisory and monitoring power is delegated to shareholding agencies in the intermediate layer. Such highly concentrated ownership leaves shareholder meetings and board composition dominated by quasi-administrative bodies which could act at the expense of both state and minority shareholders. Where both entities operated in the same industry, related-party transactions became unavoidable. Shareholding agencies likewise have their own agendas and goals. To the extent that insiders’ interests diverge from those of other stakeholders, including minority shareholders and central government, the latter’s rights and interests can be potentially overridden and sacrificed, as illustrated by frequent cases of insider trading and asset tunnelling (Aharony et al., 2011; Jiang et al., 2011; Peng et al., 2011).¹⁴

Since the mid-2000s, most restructured SOEs – in particular those under central control – have formally reported significant increases in their production, profits and tax payments. Enough performance improvement had occurred for central leadership to announce that corporate restructuring had come to a successful end. As Figure 5.2, demonstrates, despite their reduced numbers, aggregate profit in industrial SCCs increased over 30-fold, from RMB 52.51 trillion in 1998 to RMB 1645.76 trillion in 2011. Although profit declined by 10 per cent during 2008 amid the wider financial crisis, RMB 90 billion remained considerable. Where these corporations already represented the entrenched interests of pre-corporatization era, enterprise reform has produced “a vast, tangled mass of economic and bureaucratic relations” (Naughton, 2006). In particular, as a result of the 1994 tax treaties, most dividends

¹⁴ Aoki (1994) pointed out that such insider control is a prevalent phenomenon inherent in the transitional economies.

and after-tax profits became “bottled up” within the intermediate layer of shareholding and group companies – for example, the actual profits submitted to central government in 2010 accounted for less than 2.2 per cent of total profit. While share listing did not return any dividends to the state, rising corporate power has been further extended by the central leadership’s endorsement of nurturing the “commanding heights” or “national champions” (Szamozzsegi and Kyle, 2011). Anecdotal evidence – such as the prolonged restructuring of the telecommunication industry – suggested a tendency for ministries and large enterprise to develop near monopolies reliant upon political connections to ensure privileged subsidies. Therefore, with expanded economic and political clout, the objectives of the state and SCCs are not necessarily synonymous.

Figure 5.3 Total Profits and Number of Industrial SCCs (1998-2011)



Source: China Statistical Year Book 2011

The growth of corporate power has raised concern about ability of central government to pursue reforms that challenge large business interests. For example, the severe and persistent air pollution which enveloped Beijing in January 2013 raised particular public anger towards the country’s two largest oil companies, China National Petroleum Corporation (CNPC) and Sinopec. Although central government issued IV Diesel Emission Standards in 2005, implementation was repeatedly delayed by both oil producers. To CNPC and Sinopec, the costs of upgrading refinery facilities should be carried or subsidized by the state. While others criticized these two companies for pursuing economic self-interest at the expense of public health, certain ministerial-agencies including the Ministry of Environment Protection find it difficult to make challenges them. Open disputes between central government and SOEs appear unusual where corporations become more adept at handling central government

directives. One prominent example was the slow withdrawal of central SOEs from real estate markets. In March 2010, SASAC ordered 78 central SOEs to exit property market investment in order to curb a possible housing bubble. However, reports suggested that their compliance was mixed at best. Six months after the stipulation, Business China indeed reported that, in order to circumvent SASAC's mandate, central SOEs were trying to remarket on-going projects as low income housing, while continuing to sell them as commercial residential units. The same month, Shenzhen Newspaper reported that these 78 enterprises retained over RMB 110 billion (US\$15 billion) in real estate assets and were moving slowly towards disinvestment due to lucrative returns. In February 2010, SASAC's Deputy Director Shao Ning acknowledged that only 14 enterprises had fully complied, and half had only complied two years later. This reveals the emergence of major corporate entities as stronger political players and explains the difficulty which central government faces when establishing more effective governance mechanisms for the state sector (Dong, 2011).

The increasing entrenchment of corporate interests slowed reform and impaired the legitimacy of the ruling party. Since 2012, a series of corporate scandals and corruption cases aggravated public discontent about excess managerial perks in the state sector.¹⁵ The widening wealth gap and rising social inequality contradict normative political guidelines for "Building a Harmonious Society" (*Jianshe Hexie Shehui* in Chinese).¹⁶ While social disparity undermines party legitimacy it only has more direct impact once it is finally uncovered and/or disputed. These unchecked remuneration schemes increase the legitimacy deficit when they clearly only privilege selected enterprise insiders (Beetham, 1991). Certain high-income sectors such as financial service, public utilities, transportation, and telecommunications have arguably higher growth rates of income per capita compared with other non-state sectors. For certain observers, corporate insiders and their politician allies are the primary beneficiaries of 30-year enterprise reform, even if this threatens to delegitimize ongoing economic liberalization (Dickson, 2003). A noticeable incident occurred in April

¹⁵ It is noteworthy that ever since the centrally planning period, the privilege enjoyed by the enterprise managers were not merely based on salaries and bonuses, but also on sizable perks, including assignment of better and larger apartments, private use of cars, availability of "corporate accounts" for business lunches and dinners, entertainment, domestic touring and the like (Qian and Stiglitz 1996). A senior managerial position often entails distinguishable and non-explicit discretion over a huge amount of control rents, especially in large-scaled enterprises and industrial sectors stipulated as "commanding height". With increasing managerial power delegated to enterprise cadres, they tended to abuse their power over remuneration and exercise favoritism to a much greater extent (IN5, 2012).

¹⁶ President Hi Jintao's concept embodied the ideas of social justice and improving the life standard of those who were marginalized by the reforms and were unable to receive enough public attention.

2011, when Tianya, one of the most popular Chinese internet forums revealed Sinopec's Guangdong branch of spending hundreds of thousands on luxury wine and alcohol. The unveiled scandal reinforced a widespread belief that the state owned assets in large corporations are being used to serve the interests and lavish lifestyles of a tiny group of corporate insiders (Higgins, 2011).

To sum up, China's SSG reform involved the re-delineation of authority and responsibility between the central ministries and local governments. The transformation of their roles, from the supervisors implementing administrative directives to the 'intermediate principals' overseeing enterprise management, reflected expanding markets. The re-delineation of governance authority focused upon the three key lines of residual rights, i.e. revenue remittance, asset disposal and personnel appointment. It took place simultaneously with legislative reform of the state budget and capital markets, for which the inherited fragmented authoritarianism provided the institutional base. In light of rising central fiscal burdens, local governments reclaimed their fiscal and administrative authority over small and medium-sized SOEs. However, ownership control allowed the restructured ministries to continue their influence and/or discretion over large SCCs. The entrenchment effects of ownership concentration adversely impacted upon investor protection. The rise of large corporations as powerful political actors exacerbated managerial malpractice and conspicuous executive perquisites and challenged the reconsolidation of state ownership rights. It is reasonable to expect that China's SSG reform will be politically contested each step of the way.

5.5 Managers and SOEs

The Chinese party-state traditionally adopted a Leninist *nomenklatura* system upon its original establishment, in which the party chief commissions appointments at various levels and retains the ultimate authority over the key personnel concerned. Managers in SRUs were appointed or dismissed through various bureaucratic apparatus and enjoyed the same remuneration as government officials or "state cadres" (*guojia ganbu* in Chinese). In the centrally planned era, the primary task for enterprise cadres was to perform a complex repertoire of production quotas and administrative directives imposed by their administrative superiors. Between 1955 and 1985, China's state sector employed a highly centralized eight-grade remuneration system in which the social status and political prestige enjoyed by

managers was determined by their administrative rankings in the stratified hierarchy.¹⁷ In this case, productivity and other financial objectives had little influence on managers' remuneration and promotion prospects. For Kornai (1992, pp.223), an egalitarian, grade based seniority system had filled the disciplinary vacuum left by the abolition of private property. It also maintained ideological compliance among enterprise managers through party cells (You, 2002, p.111). Party Committees decided which pro-party activists were rewarded and who were the "backward elements" (*luohou fenzi* in Chinese) to be discriminated against. As material incentives and political performance became more closely linked, enterprise managers became bureaucratic agents committed to socialist tenets.

Reform since 1979 changed relationships between managers and SOEs. Faced with new economic pressures, managers were initially "shaken out of their dependence on the plan" and forced to compete more along market lines (Shirk, p. 211). Reform then permitted managers to produce and sell products which the plan had not specified. They became gradually detached from administrative directives and became more responsible for firm operation and performance above all (see also Wu, 2005, p. 153). In particular, grade-based seniority wage allocation was dismantled as enterprise managers created incentives from retained profits.¹⁸ Throughout the 1980s, incentive pay and other performance-linked programs spread, and their share of total remuneration increased steadily from 2.3 per cent in 1978 to 24 per cent in 1992, while average nominal wages in state and collective sectors almost tripled (Hussian and Zhuang, 2000).

For Walder (1991), managerial autonomy and market-oriented incentives transformed the politics of the state sector (see also Tam, 1999, 2000, and 2002). Given their experimental nature, managers did not treat reforms as legal commitments, and thus bargained to revise contractual terms instead. Without effective auditing, managers might inflate costs and hide profits. If the enterprise performed poorly, blame was shifted to "objective reasons" (*keguan yuanyin* in Chinese) – such as changes in prices and demand – and there were appeals to revise profit remittance obligations downwards (IN9, 2010; IN34, 2011; see also Shirk, 1993; Sun and Tong, 2003). Enterprise managers sought bonuses for profit, but not responsibility for losses (Wu, 2005, pp. 150-151). Moreover, for Walder (1989, 1994) and

¹⁷ The aggregate national wage bill and growth were both arbitrarily decided by the MOF.

¹⁸ By 1986, wage reform created a dual-track incentive structure in managers' salaries: the fixed part of standard wages which were still based on the past eight-grade wage scheme, and the decontrolled part which was made up of bonuses.

Huang (1995, 1996), under fiscal decentralization local bureaucracies had particular financial incentives to collude with enterprise managers. Local industrial bureaus bargained on behalf of subordinate enterprises against central ministries to ensure that more revenue would be kept at the local level. As Xu (1989, p. 26) put it, “a tacit agreement ... to dilute the center’s interests and strengthen the interests of the local government and enterprises” had emerged. By spotting ideological differences among central bureaucracies, certain SOE managers, allied with local political entrepreneurs, could refuse to comply with any initiatives detrimental to their own and local interests.

However, enhanced managerial incentives could be achieved at the expense of more fragmented ownership rights, while still leaving the relationship between managers and the party-state relatively intact. So-called power delegating and profit sharing referred to sharing residual control and other claims between the state and enterprise insiders (Wu, 2005, pp. 150). Under more modern CG systems, most rights delegated to SOE managers are normally exercised by the board of directors as entrusted by shareholders. Without effective supervision, power delegation inevitably left enterprise managers relatively unchecked (Faleye et al., 2006). Moreover, when the 1988 Enterprise Law designated the general manager as “legal-person representative”, that legal person was assumed to be one man due to the lack of relevant legal tradition. Opportunistic managers reportedly used such ambiguity to project themselves as the personal incarnation of the corporations which could dispose of corporate property at their own discretion. Examples of state asset stripping and insider corruption suggested enterprise insiders often used distorted ownership to convert their de facto partial ownership into a de jure complete one (Frydman et al., 1993; Dobrinsky 1996). Once the party-state retained ultimate power over vital operational and personnel decision making, managers were never completely detached, either financially or politically, from the corresponding hierarchy. The inheritance of the bureaucratic hierarchy, interwoven with cultural tradition of personal connections (*guanxi* in Chinese), still impinged upon managers’ career progression. The power of the Party in personnel selection and job allocation restricted the mobility of enterprise managers and discouraged further initiatives and innovations (Wong and Slater, 2002).

Since the early 1990s, corporatization sought to “replace a pliant and negligent state owner with profit-seeking shareholders to monitor management more effectively” (Clark, 2003, p. 499). By transforming SRUs into business entities with limited liabilities, central

government sought to impose hardened budget constraints which would make managers more accountable (Lin and Zhu, 2001). However, under highly concentrated ownership structures, different quasi-administrative agencies such as shareholding agencies and group corporations could still intervene in the appointment and dismissal of key managerial staff as well as remuneration schemes (Wu, 2005, pp. 159-163). In particular, they could appoint and supervise themselves and affiliates as salaried directors of listed companies, even though their nomination and evaluation was held secret within this intermediate layer (Wu, 2005, p. 160). Naughton (2006) used a “black box” to depict this middle layer as “the least transparent” and “least reformed” part of SSG structure. This made certain managers collude with the “leading members” from parent companies, making insider control even more problematic (IN1, 2010). Directors and managers within a unified “leading team” were often left unchecked and able to pursue their own interests at the expense of both state and minority shareholders’. Such insider collusion emerged in the absence of effective external monitoring: SOEs and SCCs were not all covered by the legal and regulatory framework for listed companies (OECD, 2005b).¹⁹ Moreover, mainland stock markets did not impact upon the disciplining and supervising of directors and senior managers under concentrated ownership. This created opportunities for further managerial opportunism to misuse state assets for private purposes and lower operational efficiency (Yeo, 2013).

At one time, central government relied upon political oversight to address insider control. The *nomenklatura* system was preserved largely through corporatization reform and paralleled with SSG hierarchy in many corporatized SOEs. Directors and managers may regard the party’s final endorsement of appointments and dismissal as the only and most viable mode of discipline. However, economic liberalization has reduced conventional ideological oversights for curbing managerial malpractices (Walder, 1991; Naughton, 2006). The party-state struggles to coordinate political control with the very market-oriented institutions which it claims to seek. With regards to corporate managers, it faces the dilemma of a dual identity in which the fiduciary relationship between corporate managers and shareholders is overshadowed by the party’s persistent influence, subordinating economic efficiency to the pursuit of political objective (Pei, 2009). Reform leadership thus increasingly realized that corporate managers needed the discipline and transparency of improved SSG and therefore sought a substantial but incremental combination of market-

¹⁹ By the end of 1004, none of the 189 central SCCs directly under SASAC’s control and only a minority of their partially owned subsidiaries are listed (see OECD, 2005b).

based governance with continued party-state oversight over strategic state enterprises (Pearson, 2005; Yeo, 2013). In remaking its legitimacy, the party-state required new channels to institutionalize oversight over corporate management. The effectiveness of China's SSG thus depends on not only the up-stream functioning of state ownership rights, but also the organisational set-up within SOEs, i.e. the relationships and distribution of power among the company organs" (OECD, 2005b, p. 311).²⁰

Current policies also seek to strengthen the function of BODs, using comprehensive listing (*zhengti shangshi* in Chinese) to change the intermediate layer where various quasi-administrative shareholding agencies will be listed or simply abolished.²¹ In the 16th SASAC-Temasek Directors Forum, Li Bing, General Director of Bureau of Enterprise Restructuring of SASAC depicted a well-functioning BOD as follows: (1) an increased proportion of independent directors accounting for more half of all board members; (2) clarified rights and responsibilities between BOD chairs and CEOs; (3) an increased proportion of employee representatives and improved employee democracy; (4) separated roles for policymakers and corporate management; (5) improved monitoring of corporate management via supervisory panels; and (6) a more active and influential role for BOD committees (Sun, 2012). Certainly the idea of BODs is not entirely new in Chinese SOEs, but what makes it unique is that the Party's ever stronger supervisory power is increasingly linked into market-oriented governance institutions (Yeo, 2013).

First, directors and corporate managers are subject to renewed selection and evaluation criteria that are increasingly economic-oriented. The "Interim Regulations for Operation Performance Assessment of Central SOE Legal Representatives" stipulated that managerial remuneration and career progression should be based on several business performance indicators including total profit, economic value added, growth rate of state asset value, social responsibilities and total asset turnover. Under the new system, there are five levels of performance, ranking from A to E (A being the most satisfactory). While technological innovation is well weighted in assessing managerial performance, negative indicators include severe investment loss, failures in operational safety and product quality, as well as financial irregularities (Leng, 2009). At the National State-owned Assets Supervision and

²⁰ Qin Yongfa, the deputy director of the Working Group Office for the Experiment of Board of Directors of SASAC, claims that institutionalizing the channels of the party's political role in central SOEs is the primary concern for the leadership.

²¹ Since 2005, 30 central SOEs including Baoshan Steel and Datang Telecom Corporations have been chosen to implement BOD reform according to international standards.

Administration Work Conference in early 2009, Huang Shuhe, deputy director of SASAC, explicitly asserted that managerial assessment must further take into account such issues as liquidity, investment risks and operational cost.

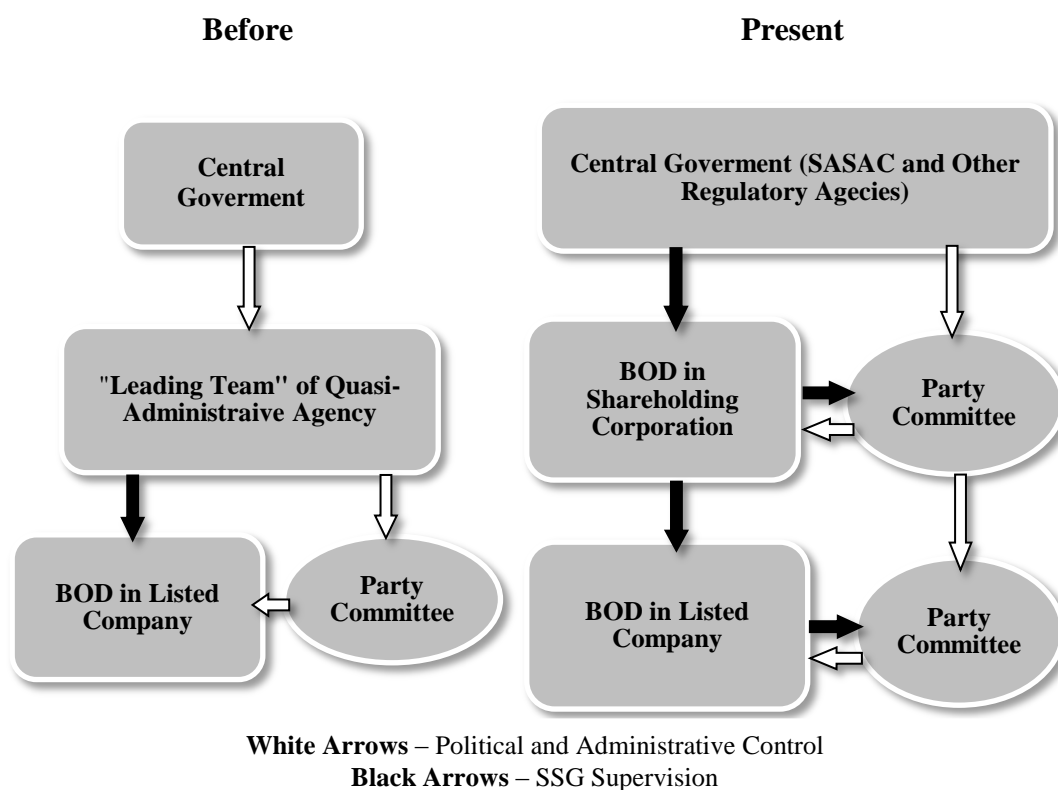
Second, political oversight has been further institutionalized. Along with the corporatization of quasi-administrative agencies, central leadership employs a “two-way intervention” (*shuangxiang tuijin* in Chinese) approach in order for oversight over corporate executives in the intermediate layer. The context for this was a sense that excessive power delegation (or decentralization) caused the ‘state owner’ to “lose control over the key macroeconomic levers and that prudent recentralization is necessary” (Saich, 2011, p. 285). As Figure 5.4 shows, two-way intervention occurs when Party Committee members join the BOD, while other BOD members join the committee at the same time. This provides an institutionalized channel to maintain the CCP’s political supervision (see also Yeo, 2013). Rather than rely upon administrative and political arms as before, regulatory bodies supervise corporate managers/state cadres using renewed criteria for managerial appointments and evaluation.

Third, external directors become proxies for central-leadership and thus play an increasingly important role in managerial supervision. Elsewhere independent/external directors formally ensure that corporate management is both accountable and effective, having been selected by votes at the general meetings of shareholders and paid for by the company, but not in China. Here internal and external directors in shareholding agencies and listed companies are nominated and appointed by corresponding regulatory agencies. The limitations of supervisory boards (SB) in managerial monitoring have led the party-state to reconsolidate its authority over external director appointments.²² Thus external directors reflect and pursue its stated desire to safeguard and enhance state asset value. Meanwhile such directors constitute the majority of the standing committee which appears only in non-listed shareholding agencies and has assumed responsibility of making major business plans while overseeing performance. More external directors have been considered to be the linchpin for enhancing regulatory capacity. For Yeo (2013), reform leadership does not reflect either a purely market-based nor control-based system; instead it has followed western practices, and skilfully adapted them to China’s institutional environment. As central leadership regulatory capacities have been further enhanced, BODs appear like market-oriented institutions being

²² For the central leadership, the SBs are simply insufficient because supervisors often have less business expertise and are not involved in managerial appointments.

adapted to serve party-state's interests. For Naughton (2006), the state's renewed focus on governance reform can make it both the ally and adversary of corporate managers. It is an ally of large corporations in that the continued interventionist approach aims to increase the value of state assets and their international competitiveness. A vital strand in achieving this goal is to enhance oversight over the managerial stratum and reduce agency costs. In this political environment, reformers become entrenched management's most evident adversaries.

Figure 5.4 Managerial Oversights in SCCs



To summarize, the demise of central planning and rise of a market-based economic order changed Chinese enterprise politics. With fewer directives and resources coming from the center, managerial initiatives were enhanced, and thus ideological compliance became less binding upon individual managers. However, their expanded autonomy did not bring greater responsibility for enterprise performance. Under highly concentrated ownership, quasi-bureaucratic executives often dominate. Hence, the efficacy of transplanted governance mechanisms, including boards of directors and supervisors, has been largely compromised. Given a tendency to insider entrenchment, once-rigid and all-encompassing nomenklatura control has changed, as can be inferred by increasingly market-oriented cadre evaluation criteria. In pursuit of a more globally competitive state sector, the existing governance

framework helps the party-state institutionalize its chosen political safeguards against management corruption and other malpractices.

5.6 Public Investors and SOEs

The emergence of public investors in China is linked into the development of the non-state sector and corporatization reform. Since embarking upon economic reform, China has witnessed the rapid emergence of private business and dramatic inflow of foreign capital. Changed rules and institutions governing the state sector and national economy have provided foundations for continued economic growth. Increased industrial and agricultural output, coupled with high-standing household saving rates – estimated at 23 per cent of disposable income – enabled the emergence and proliferation of non-state investors, most notably, institutional investors. Over the restructuring of the state sector, the party state allowed the non-state sector to take over small and medium-sized SOEs while seeking to channel non-state capital, in particular foreign institutional investors, into large SOEs.

By quietly dismantling the economic and administrative structure that was supposed to restrain it, market forces and profit motives increasingly impact upon economic development in both urban and rural areas, increasing opportunities for private business. With economic liberalization, the legal position of the private sector was further secured by the CCP 15th Congress in September 1997 when recognized as “the important component of the socialist market economy with Chinese characteristics”. Given this ideological breakthrough, non-state investors entered the state sector to address its daunting capital problems. However, the “ownership diversification with Chinese characteristics” does not intrinsically imply unequivocal asset transfer into private hands overturning the continued dominance of state ownership in large corporations (Cao, 2001). Accumulated non-state capital is put to state use and subjected to the control of dominant shareholders under the euphemism of “corporatization” or “securitization” (Cao, 2001).

However, expropriation by insiders concerns public investors under concentrated ownership (Shleifer and Vishny, 1998; Leuz et al., 2003; Gul et al., 2010). A most widespread abuse is asset stripping by shareholding entities at the expense of listed companies and minority shareholders through abusive related party transactions among firms of the same group, intra-group lending or guarantees, and excessive cash dividends (OECD, 2005b). As noted, parent companies typically transfer productive assets to their listed subsidiaries, retaining

liabilities and redundant staff (Green, 2003). This makes it likely that, lacking a proper fiscal system to socialise such burdens, parent companies exploit subsidiaries to meet their fiscal commitments. These problems have been characterized as resulting from “ownership without constraint”, and have lately resulted in major losses for individual shareholders (OECD, 2005b, p. 314). Although Chinese regulatory bodies and stock exchange officials acknowledged the importance of investor protection, there are still significant barriers preventing minority shareholders from asserting their rights (Tomasic and Andrews, 2007). Based on the investor protection index developed by La Porta et al. (1999, 2000), MacNeil (2002) calculated a score of 2 for China compared with a 'normal' global average of 3 and maximum of 6. The World Bank found that China scores only 5 out of 10 in the index of investor protection with a global average of 5.2, as indicated in Table 5.1.²³ Wu Jinglian, arguably China's most prominent economist, publicly claimed that “China's stock market is no better than a casino, since in a casino there are rules”. Green (2003, pp. 5-6) depicted this poor investor protection situation thus:

“minority shareholders are ignored at the shareholder's meetings, and frequently abused outside them. Company disclosures are so unreliable as to make real supervision of corporate activities impossible. In terms of transfer of ownership, there are also important limits: individuals face huge obstacles in gaining influence over listed firms, state shareholders do not yet have the right to sell their shareholdings and changes of ownership are usually negotiated through, and approved by government bodies. Few dividends are paid and company funds are often siphoned off by majority shareholders, because of these deficiencies, no true market in corporate ownership yet exists”.

For emerging economies, lack of investor confidence can induce stock market volatility which hampers capital-raising (Johnson et al., 2000; Prasanna and Menon, 2012; Brooks et al., 2012). The Chinese market has been notably narrow, dominated by small retail shareholders and short-term speculative trading, with significantly inflated valuations (OECD, 2005b). For central leadership, underdeveloped financial markets obstruct corporatization and state sector restructuring, creates further legitimacy concerns. Since 2000, the Securities Regulatory Commission (CSRC) has pursued successive new market-oriented policies in the name of restoring stock market confidence, including strengthening

²³ This index is the average of a series of investor protection indicators including the extent of information disclosure index, the extent of director liability index, the ease of shareholder suits index. Each of them ranges from 0 to 10, with higher values indicating stronger investor protection.

minority power, imposing duties on controlling shareholders, restricting related-party transactions, improving board independence and information disclosure.

Table 5.1 Regional Comparison of Investor Protection 2011

Regions and Economies	Disclosure Index	Director Liability Index (0-10)	Shareholder Suit Ease	Investor Protection index
East Asia & Pacific	5.0	5.0	6.0	5.4
Eastern Europe & Central Asia	7.0	4.0	6.0	5.7
Latin America & Caribbean	4.0	5.0	6.0	5.1
Middle East & North Africa	6.0	5.0	4.0	4.9
OECD high income	6.0	5.0	7.0	6.0
South Asia	5.0	4.0	6.0	5.0
Sub-Saharan Africa	5.0	4.0	5.0	4.5
China	10.0	1.0	4.0	5.0
Hong Kong SAR, China	10.0	8.0	9.0	9.0
Russian Federation	6.0	2.0	6.0	4.7
Taiwan, China	7.0	4.0	5.0	5.3
United Kingdom	10.0	7.0	7.0	8.0
United States	7.0	9.0	9.0	8.3
Global Average	5.3	4.5	5.7	5.2

Source: World Bank, Doing Business Project (2011)

For example, in 2000, the CSRC issued regulations to restrict controlling shareholders' involvement in related power transactions, including voting power in shareholder meetings and issuance of loan guarantees. In 2002, it formulated its "Code of Corporate Governance" for listed companies specified principles for investor protection and related guidelines for BODs and SBs. In particular, every listed company should have at least two independent directors and, by June 2003 had to account for at least one third of all board members. Disobedience brought administrative warnings, heavier fines and possible criminal prosecution, since the Supreme People's Court has allowed private suits against listed companies. Such regulatory endeavours indicate the senior leadership's concern to protect public investors and improve CG. For Tricker (2012), although these codes and regulations

for investor protection largely mirror those in the West, detailed requirements were even stricter than in Hong Kong and other developed markets (Tenev et al., 2002).

However, there were gaps between actual implementation and the CSRC's original vision. Many of the regulatory difficulties faced by transitional economies stem from the absence of economic-political conditions conducive to effective investor protection. This is especially so for China where judicial independence and civil rights are limited. In practice, the enforcement of disciplinary provision can arouse resistance from these enterprise groups who regard themselves as “selfless parents” bearing the tremendous sacrifice of non-performing assets and unproductive employees. They implicitly assume that listed companies, representing the most profitable “carved out” assets for IPO financing, are obligated to fulfil their financing needs at minority shareholder expense. Such a parent-child type relationship can encourage investor expropriation, including soft loans from listed companies on a long-term basis, the use of listed companies as guarantors for further bank loans, and the sales of listed companies' assets at inappropriate prices. In reforming the “split share structure” (*guquan fen zhi* in Chinese), and notwithstanding the concession of protecting the interests of those tradable-share owners backed by central bureaucracies, parent companies have been challenged about dishonouring promises to holders of tradable-shares. For example, certain companies that promised to buy back shares, or offer cash compensation in the event of a price drop, have not done so. For example, Shanghai's Baoshan Iron & Steel Corporation, a central SOE selected to conduct share reform, was roundly criticized for failing to keep its promise to intervene if its share price fell below RMB 4.53 (SinaFinance, 2005). Cooper (2008) found that concentration of shareholding on the part of parent companies was generally associated with lower cash compensation to minority shareholders. Vulnerable minority shareholders also encounter lack of judicial independence. Local People's Courts are reportedly reluctant to accept cases in which powerful political entities, such as state shareholding agencies, are involved (see Lin, 2001; Braendle et al., 2005). Arguments about whether party hegemony will dissolve aside, public investors are still vulnerable against controlling shareholders' expropriations (Lubman, 1999; Lin, 2001; Potter, 2005; Braendle et al., 2005). Guo Shuqing (2011), Chairman of the CSRC identified the key difficulties as follows:

“Insufficient judicial assistance for investor protection, together with the absence of a vibrant and highly efficient market for corporate control and the nonexistence of market of

professional managers, has resulted in ineffective restraint of the market mechanism over corporate management. Lack of awareness of value investment among individual and institutional investors also weakened the supervision of listed companies.”

In 2007, the China Banking Regulatory Commission (CBRC) and CSRC also increased ownership ceilings for foreign capital in listed securities traders, enabling overseas institutional investors to act as external disciplinary mechanisms (Wu, 2010). In January 2012, the CSRC established an investor protection bureau to conduct relevant research and handle investor complaints, in particular individual investors (Lu et al., 2010). The CSRC also sought to merge the bureau with several institutional investors so that the resulting agency could participate in shareholder meetings and file complaints or lawsuits on behalf of individual investors (Lu et al., 2011). With increasing complaints and criminal prosecutions against expropriating insiders, the CSRC publicly stated that “the policy of ‘zero tolerance’ should be practiced for insider trading, market manipulation and other violations, all of which will be prosecuted” (CSRC, 2013).

In searching for reform motivations, observers such as Green (2003) have noted that regulatory endeavours and statutory improvement of public investors' position were closely linked with shifting government priorities in enterprise reform, welfare development and budgetary conduct. Previously China's securities markets financed SOE restructuring (see Green, pp. 171-172). Regulatory priorities would curb potential malpractices during state asset transfer, whilst public investors and market confidence were of less concern. However, the agenda has lately changed as existing regulatory structures faced other issues regarding SOE performance deterioration, pension reform urgency, and mounting budgetary deficits. A year after the enactment of CSRC's major reform measures, private research by one Chinese securities company estimated that the gap between funds available and needed in mainland stock markets ranged anywhere between RMB 20 to 80 billion. It is therefore clear that, in order to attract more investors on a larger scale, the government had to do more than just detain further A-Share issuance. In addition, faced with an ageing society, it is important to diversify investment channels and increase return rates for pension assets in China, estimated to grow from RMB 125 billion in 2001 to 8.3 trillion by 2020. Whether privately or publicly managed, capital from pension, mutual funds and insurance funds needs to be invested in well-regulated securities markets with effective investor protection in order to achieve better investment returns. Although Chinese stock markets can offer quick returns, they appear ill-

suited to managing national pensions. Financial fragility associated with weak investor protection could negatively impact upon firms' access to external finance, and hamper economic growth and social stability, as in the 1998 Asian Financial Crisis. The reform leadership increasingly realized that maintaining investor confidence is important for both economic and legitimacy concerns. Indeed, continued investor protection improvement relied upon the central leadership's priorities for economic reform and regulatory practices. A recent compelling example was SASAC's unsuccessful nomination for the BOD chairman of Gree Electric Appliances (Qi, 2012). Although SASAC retained a majority shareholding of 20 per cent, minority investors, including several mutual funds and insurance companies, jointly exercised veto power over its nomination. As central leadership relinquished control over less important enterprises, SASAC's shareholding in Gree Electric Appliances became less dominant compared with other central SOEs. In its case, selective withdrawal of state capital enabled more proactive governance practice by institutional investors.

To summarize, rapid economic growth and the improved income levels led to the rise of public investors in the reform agenda. Where complementary institutions for sound governance practices, such as developed capital markets and judicial independence, have yet to emerge, Chinese public investors remain vulnerable to expropriation risks and managerial malpractices often associated with highly concentrated ownership. However, changes in the economic environment introduced other stakeholders, bringing pressure upon existing governance institutions: inherent expropriation risks and persistently low investment returns not only prolonged corporate restructuring, but hindered the development of a national pension system. In order to nurture sufficient demand, stock markets are required to attract small investors on a larger scale than before, due to the rising influence of formal institutional investors. The resultant economic and legitimacy concerns further prompted central policy makers to initiate successive regulatory reforms in order to restore the trust and confidence of market participants. This, in turn, has contributed to the growing aversion to insider control and investor expropriation.

5.7 Overseas listing and International Expansion

International listing has been designated as providing leverage for more stringent governance institutions in addition to accessing external capital (Coffee 1999, 2002; see also Licht, 2003, 2007; Sun et al., 2013). National policymakers envisioned its increasing importance for pursuing an internationally competitive state sector (Sun and Tong, 2003; Hung et al.,

2008; Guest and Sutheland, 2010). Moreover, these listed companies provide exemplars for others to follow, and thus advance SOE reform. Zhou Daojiong (1995), a former CSRC chairman, remarked:

“recommending medium and large-sized SOEs for overseas listing is useful in raising necessary foreign capital; but more importantly, it prods SOEs to learn from the successful experience of foreign companies, helping them match international standards and making it possible for them to compete in the international market” (Ifeng, 2008).

Hong Kong is a favoured hub for overseas listing. For Sun et al. (2013), H-share firms dominate in terms of both number and size compared with other firms listed elsewhere, such as New York (N-share) and London (L-share).²⁴ Besides its status as the regional financial center, Hong Kong is an attractive listing venue for Chinese SOEs because it is “blended with the cultural, historical and linguistic factors” arising from the proximity of the East and West (Meng, 2011, p. 256; see also Pagano et al., 2002; Xu, 2011). In May 1993, the State Council promulgated the Mandatory Provisions of Articles of Associations for Companies to be listed in Hong Kong. These Mandatory Provisions delineated the rights and obligations between the Chinese SOEs and investors inter se, and minimized the discrepancies of legal origins and authorities between these two jurisdictions regarding such aspects as share repurchase, shareholders’ general meeting, directors’ duties, board structure, information disclosure, corporate restructuring and dispute resolution (see Meng, 2011). On 15 July 1993, Tsingtao Brewery made history as the first restructured SOEs to float shares in Hong Kong Stock Exchange (HKSE), followed by eight more companies in the first batch.²⁵ On 8 August 1994, the Hang Seng China Enterprise Index was launched to track the performance of all H-share companies.

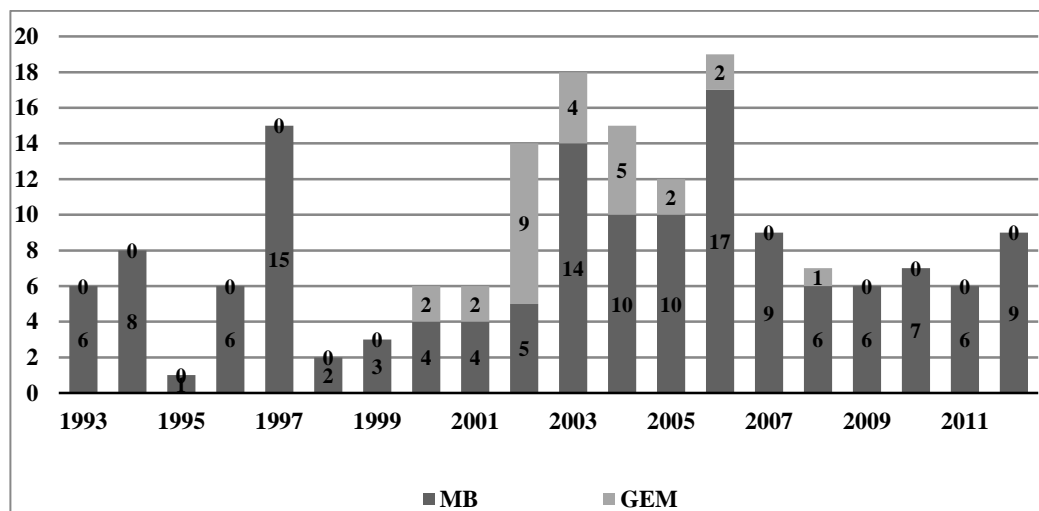
Figure 6.1 shows the number of Chinese companies listed in the Main Board and Growth Enterprise Market of HKSE between 1993 and 2012. During this period, a total of 175 IPOs were successfully launched, raising capital of more than HK\$ 11.3 trillion (US\$ 1.47 trillion). While the last decade has witnessed a sharp increase of H-share IPOs, the average raised capital increased considerably from HK\$ 2.5 billion over the 1990s to HK\$ 10 billion

²⁴ In fact, most N-share firms are traded in the form of American Depositary Receipts (ADRs) with the underlying shares listed Hong Kong.

²⁵ The other eight companies were Shanghai Petroleum, Maanshan Iron & Steel, Beiren Printing Machinery, Guangzhou Shipyard, Sinopec Yizheng Chemical Fiber, Jiaoda Kunji High-Tech, Dongfang Electrical Machinery and Tianjin Bohai Chemical Industry.

hereafter. Successful experimentation with medium-sized, largely local SOEs provoked more large-sized SOEs to list shares abroad (Ewing, 2005; Meng, 2011). In 2006, the world's largest and fourth largest IPOs, namely the Industrial and Commercial Bank of China and the Bank of China, elevated HKSE to the world's second largest stock exchange for IPO financing, ahead of New York and just behind London (Yang and Lau, 2006).

Figure 5.4 Number of H-share IPOs (1993-2012)



Source: Hong Kong Stock Exchange

The overall geo-economic context and accelerated pace of overseas listing meant that the entire Chinese state sector becomes increasingly open to international influence (see Deeg, 2005; Djelic and Quack, 2007). The involvement of international capital could provide further impetus for sound CG practices, in particular effective investor protection and information disclosure (Coffee 1999, 2002). In particular, to prepare for international listing, many SOEs have progressively restructured in line with international standards, emphasizing information disclosure and board independence (see Jia et al., 2005; Sun et al, 2006). With the state's continued pursuit of better managerial oversight, overseas listings arguably impose more stringent legal requirement and monitoring upon corporate insiders. This in turn addresses interest misalignment between state owners and public investors, where policymakers believe that entrenched insider control limits efficiency and competitiveness improvements (Madera and Sun, 2005; Sun et al, 2006). Anecdotal evidence suggests that listed SOEs claim to align governance practices with global standards. Domestic regulatory agencies and listed companies have been pressured to improve corporate transparency and guarantee investor rights following accounting scandals. The direction of China's SSG reform, to a certain extent, hinges upon how market participants regard the governance

system and prevailing practices (Clarke, 2003). In one comment on a lawsuit against a state-owned chipmaker, the Nasdaq-listed Semiconductor Manufacturing International Corporation, attorney Omer Ozden, asserted that:

“Chinese companies are very sensitive to their valuation. With valuations so key to Chinese companies; we should expect to see considerable efforts on their part to improve their disclosure, corporate governance and accounting standards over the next few years so as to avoid similar drops in trading prices. American and other international investors will also begin to understand Chinese companies better and they will be less inclined to paint Chinese companies with the same brush, as has been the case over the last few years” (Asianlaw, 2004).

Cross-border mergers and acquisitions (CM&As) by Chinese multinational enterprises (MNEs) provide a particular testing ground to assess similar judgments by international investors. The cumulative abnormal returns (CARs) around CM&A announcements have been widely used to infer value creation (destruction) effects associated with firm and deal-specific factors (see Mock and Yeung, 1992; Chen and Young, 2010; Gubbi et al., 2010). Although this effect is often discussed using the language of cooperation and synergy, its variation can also be attributed to the organizational structure and SSG features of acquiring firms (see Lien et al., 2005; Buckley and Casson, 2009; Buckley and Strange, 2011; Filatotchev and Wright, 2011). The current majority-voting rule generates shared concerns that rights of minority shareholders will be easily overlooked, particularly when concentrated ownership structures enable corporate controller to dominate (Xi, 2006; Hovey and Naughton, 2007). Accordingly, minority investors choose to ‘vote with their feet’, given their negligible influence upon corporate controllers. In this way, CARs, as proxy for stock market reaction, are essential tools to examine how (international) investors judge prevailing governance practices in Chinese SOEs (Del Guercio et al., 2008; Fischer et al., 2009; Ning et al., 2014).

Tables 5.2a presents the CARs of different samples over 2-, 3-, 5- and 11-day event windows. After excluding companies with missing stock data, an entire sample of 476 CM&As have been identified, of which more than 50 per cent were via companies controlled and/or supervised by central government. To the extent that the observation period covers nearly more than two decades, several discrete event breaks – including the 1993 corporation reform and the 2000 “Going Out” Policy – may affect the decision-making mechanism and

quality of CM&As. In this case, the post-1993 (Table 5.2b) and post-2000 (Table 5.2c) subsamples were constructed so that the potential influence of these reform initiatives can be further assessed. The sizes for both the entire and subsamples (476, 472, and 402) are arguably sufficient for the parameter t-test (Brown and Warner, 1985; McWilliams and Siegel 1997).

Table 5.2a CARs around the Announcement Date (the Entire Sample)

CAR	Mean %	Median %	% Positive	T-statistics	W-test
CAR (-1, 0)	0.85	0.11	52	2.98***	2.01*
CAR (-1,+1)	1.00	-0.02	50	2.98***	2.06**
CAR (-2,+2)	0.71	0.12	51	1.82*	1.25
CAR (-5,+5)	0.92	0.04	50	1.67*	1.13

*** p<0.01, ** p<0.05, *p<0.1

Table 5.2b CARs around the Announcement Date (the Post-1993 Subsample)

CAR	Mean %	Median %	% Positive	T-statistics	W-test
CAR (-1,0)	0.83	0.10	51	2.88***	1.86*
CAR (-1,+1)	0.97	0.02	50	2.85***	1.88*
CAR (-2,+2)	0.66	0.07	51	1.68*	1.09
CAR (-5,+5)	0.85	-0.02	50	1.54	0.967

*** p<0.01, ** p<0.05, *p<0.1

Table 5.2c CARs around the Announcement Date (the Post-2000 Subsample)

CAR	Mean %	Median %	% Positive	T-statistics	W-test
CAR (0,+1)	0.65	0.07	51	2.81***	1.65*
CAR (-1,+1)	0.84	-0.02	50	2.90***	1.95*
CAR (-2,+2)	0.66	0.18	52	1.86*	1.50
CAR (-5,+5)	0.89	0.28	51	1.70*	1.53

*** p<0.01, ** p<0.05, *p<0.1

For the entire sample, the mean CARs range from 0.71 to 1.00 per cent. While the mean CARs over the wider event windows are positive at the significance level of 0.10, the observed positive market reaction turned out to be particularly significant over the 2-day (p<0.01, positive yield 0.85 per cent) and 3-day event windows (p <0.01, positive yield 1.00 per cent). As noted by McWilliams and Siegel (1997), the t-test statistics in event studies are

often sensitive to outliers and thus the non-parametric Wilcoxon signed-rank test has been employed to examine both the signs and magnitude of CARs. The W-statistics indicate the generally higher proportion of the positive CARs, suggesting investors' positive perception of CM&As by Chinese MNEs (see also Ning et al., 2014). Such statistical results remain robust and significant for both subsamples.

Results from the cross-sectional regression are presented in Table 5.3, with CARs over 3-day event window used as dependent variables. From Model 1 to Model 7, effects of both time trend and industrial clustering are controlled. Model 1 contains the control variables drawn from the prevailing CM&A literature (see Chen and Young, 2010; Gubbi et al., 2010), and show significantly negative correlations between acquirers' announcement returns and firm age (FA) and size (FS), return on assets (ROA) and Tobin's Q (TQ). For Winter (1998), as firms age, routinized behaviours create obstacles to adapt changes associated with internationalization, thus partially or wholly offsetting the theoretical benefit of accumulated experience (see also Zollo et al., 2002). The negative coefficients of FA echo this (see also La Porta et al., 1997, 1998; Berglöf and Claessens 2006). McCardle and Viswanathan (1994) showed that large firms are more likely to make acquisitions, as they may exhaust their internal growth opportunities (the growth opportunities signalling hypothesis, see Jovanovic and Braguinsky, 2002). Jensen (1986) postulated that large firms' managers would rather manipulate free cash flows and pursue empire-building than increase pay-outs to shareholders. As noted, large state-owned corporations in China often entail a complex web of bureaucratic relations and politics inherited from the centrally-planning era (Naughton, 2006). Such organisational complexity creates bureaucratic and societal vested interests that may seek to maintain the status quo at the expense of public investors (Duckett, 2001). For Hayward and Hambrick (1997), strong recent firm performance, measured by high ROA, gives rise to managerial hubris and overconfidence in investment decision making. That managers may overestimate potential synergies and undertake value-destroying acquisitions concerns public investors. This is particularly so given insiders' dominance over corporate agendas, as often occurs in Chinese MNEs (Brown and Sarma, 2007). Moreover, TQ of Chinese acquirers is found to have a significantly negative effect on the announcement of returns. Financial economists attribute the former to firms' monopolistic power in addition to overvaluation effects (see Lindberg and Ross, 1981; Smirlock et al., 1984; Barton, 1988; Lang and Stulz, 1994). This high market valuation, akin to what economists label 'monopoly rents', are in part due to financial privileges and regulatory exemptions, and thus less

warranted by the acquirers' fundamentals (Moller et al., 2004; Yao et al., 2008). This often leads the managers to overbid to the detriment of public investors (Su and Fung, 2013).

The six remaining models examine the effects of governance characteristics on announcement returns. For public investors, the presence of large shareholding blocks may mitigate the "free-rider" problem in decision making and management monitoring (Burkart et al., 1997; Bai et al., 2004). This can be inferred from the positive and significant coefficients of largest shareholdings (LA) (Model 3 and Model 7). However, the complex governance structure and associated expropriation risk still concern international investors (Liu and Lu, 2007). The negative coefficients of the group affiliation (GA) dummy are statistically significant in almost all cases (except in Model 2). International business (IB) researchers maintain that group affiliation brings particular benefits (e.g. Khanna and Yafeh, 2007; Guest and Sutherland, 2010) where business groups substitute for imperfect or under-developed markets in finance, labour and products. This facilitates firms' international expansion by reducing transactions costs and business risk, as in the Japanese *keiretsus* and Korean *chaebol* (see Chang and Choi, 1988; Weinstein and Yafeh, 1998). However, group affiliation may also generate problems related to rent-seeking activities, crony capitalism, and inefficient investment (see La Porta et al., 1999). In particular, the pyramid structure affords shareholding agencies considerable economic influence over corporate affairs, such as overseas investment decisions, without necessitating commensurate capital investments (Guest and Sutherland, 2010). As regards the Chinese state sector, most intermediate principals are transformed line ministries that inherited vested interests and bureaucratic politics from the centrally-planned era, and can still pursue their own objectives in the guise of "national interests" (Naughton, 2006, 2008). The World Bank (2005) has warned of resource tunnelling where proceeds from investment projects and listed companies fuel intra-group restructuring or ill-advised investments. Officials and executives of shareholding groups often act as if the "owner" on behalf of the state, and secure private benefits not shared with ordinary investors, such as political influence and opportunities for patronage or corruption (Lin and Milhaupt, 2013). The negative coefficients suggest that GA increases the risk of insider entrenchment and investor expropriation.

The positive and significant coefficients of the central government control dummy (both at 5% level) suggest that state ownership involvement is positively evaluated by public investors. To them, strategic state intervention may benefit the international expansion of

Chinese MNEs through low-cost capital and broad technological support (see Nolan and Wang, 1999; Nolan, 2007). Prior studies suggest that well financed firms (as reflected by abundant assets power) are more capable of committing resources and weathering the uncertainties of foreign operations (Aulakh and Kotabe, 1997; Madhok, 1998). These firms are more likely to enter foreign markets through integrated channels (Aulakh and Kotabe, 1997) and conduct wholly owned operations (Madhok, 1998). For public investors, financial and political supports by the central government may help these corporations “overcome the liabilities of emergingness, and serve as a mechanism for competitive catch-up through opportunity seeking and capability transformation” (Du and Boateng, 2012, p. 33). Meanwhile the positive coefficient of largest shareholding becomes insignificant after the central government control (CGC) dummy is added, suggesting that the beneficial effects of LA may derive partially from state strategic intervention. Cheung et al. (2008) maintained that minority shareholders in firms controlled by central government (or with a large proportion of central government affiliated directors) would benefit from reduced expropriation risk, given stringent supervisory criteria and high press visibility. As argued in Section 5.4, central policy makers and regulators have sufficient incentives and power to alleviate governance problems caused by entrenched insiders given significant financial stakes and legitimacy concerns. Continued reform, including the two-way intervention approach and more independent directors, could impose checks and balances that safeguard state and public shareholders' interests (see Yeo, 2013). This adds to previous research about the state actively promoting business expansion while curbing managerial malpractices (see Bai et al., 2004; Tian and Estrin, 2008; Mallin, 2011). These findings are consistent with the ‘helping hand’ interpretation of related state intervention (see Nee et al., 2007; Cheung et al., 2008).²⁶

In contrast local government control (LGC) appears to have a negative significant effect on stock market reaction (Model 6).²⁷ Bureaucratic interference and insider expropriation constitute concern public investors (see Cheung et al., 2008). For Oppen et al. (2002, p. 108) fiscal and administrative decentralization provides local governments “a certain leeway to continue to continue their involvement and interventionist activities” in enterprises. They can exercise some discretion through the approval process for overseas investment (Cui and

²⁶ That the (negative) impact of GA is increased after the CGC dummy is partialled out (in Models 4 and 5) indicates the potential positive role of central government in curbing insiders' malpractices.

²⁷ The negative coefficient of LGC dummy becomes statistically significant at 10 % level in a one-tailed T-test.

Jiang, 2009). MNEs controlled by local governments are mandated for pursuing multiple, conflicting objectives which could be detrimental to shareholders' interests (Che and Qian, 1998; Fan et al., 2012). At the same time local bureaucracies' intervention concentrates more on personnel policy issues such as recruitment, evaluation and dismissal of key managers (Wong et al., 2004). In major corporate decision makings, the executives therefore "have strong incentives to collude or maintain good relations with local elites due to the quasi-market institutional environment" (OECD, 2005b, p. 312; Hillman, 2010). Such "asymmetric dependence relationship" can aggravate insider control, and leave both state and public investors vulnerable to expropriation (Lin, 2002, p. 68; see also MacGregor, 2012). On the other hand, as OECD (2005b, p. 310) noted, "(local) SOEs were filled local politicians with no business experience or other relevant expertise and thus did not act as a check on management" (see also Chen et al., 2002). This may further aggravate investors' concerns when these firms are entering more competitive, sophisticated global markets (Lin, 2002). In many cases the complexity of pyramid and/or cross-shareholding structures helps expand the personal patronage and influence of local bureaucrats, while providing opportunities for personal enrichment (Cheung et al., 2008).²⁸ The statistical evidence here confirms other claims about widespread investor expropriation and asset stripping by local bureaucrats and managers, including the failure of Guangdong International Trust and Investment Corporation (GITIC) and the Guangxia-Lantian scandal.

²⁸ Given their continued influence over the local press and judicial authorities, local bureaucrats may feel less likely to be prosecuted for corruption and other business malpractices (Cheung et al, 2008).

Table 5.3 Announcement Returns and Governance Characteristics

	Model 1	Model 2	Model 3	Model 4	Model 5	Model 6	Model 7
Local Government Control						-0.0173* (0.00953)	-0.0156 (0.00989)
Central Government Control				0.0228** (0.00902)	0.0203** (0.00966)		
Largest Shareholding			0.000345** (0.000161)		0.000193 (0.000162)		0.000302* (0.000168)
Group Affiliation		-0.01000 (0.00815)	-0.0183* (0.00927)	-0.0196** (0.00951)	-0.0232** (0.00995)	-0.0181** (0.00903)	-0.0246** (0.00971)
Firm Age	-0.000773*** (0.000292)	-0.000568** (0.000236)	-0.000488* (0.000249)	-0.000589** (0.000237)	-0.000541** (0.000244)	-0.000592** (0.000237)	-0.000519** (0.000250)
Firm Size	-0.00513*** (0.00170)	-0.00442*** (0.00162)	-0.00481*** (0.00158)	-0.00625*** (0.00172)	-0.00627*** (0.00172)	-0.00528*** (0.00167)	-0.00553*** (0.00164)
Return on Assets	-0.00187*** (0.000602)	-0.00186*** (0.000521)	-0.00181*** (0.000518)	-0.00179*** (0.000489)	-0.00178*** (0.000488)	-0.00180*** (0.000525)	-0.00176*** (0.000522)
Tobin's Q	-0.00250*** (0.000946)	-0.00243*** (0.000877)	-0.00241** (0.000937)	-0.00235*** (0.000782)	-0.00235*** (0.000821)	-0.00255*** (0.000844)	-0.00253*** (0.000895)
Debt-Equity Ratio	4.95e-05 (4.78e-05)	3.48e-06 (3.20e-05)	1.56e-05 (3.10e-05)	3.49e-06 (3.18e-05)	1.03e-05 (3.08e-05)	6.52e-06 (3.24e-05)	1.68e-05 (3.15e-05)
Operating Profit Margin	0.000215 (0.000143)	0.000374*** (8.71e-05)	0.000364*** (9.08e-05)	0.000381*** (8.76e-05)	0.000374*** (8.91e-05)	0.000404*** (8.98e-05)	0.000392*** (9.33e-05)
Target Status Dummy	-0.0103 (0.00646)	-0.00435 (0.00673)	-0.00444 (0.00678)	-0.00337 (0.00642)	-0.00352 (0.00649)	-0.00271 (0.00626)	-0.00295 (0.00636)
Constant	-0.0129 (0.0529)	0.0611* (0.0332)	0.0508 (0.0325)	0.0805** (0.0340)	0.0726** (0.0348)	0.0839** (0.0369)	0.0726* (0.0377)
Observations	432	375	375	375	375	375	375
R-squared	0.114	0.108	0.116	0.130	0.132	0.118	0.125

Robust standard errors reported in parentheses, *** p<0.01, ** p<0.05, *p<0.1

This section has examined the impact of various SSG variables upon the announcement returns of CM&As. It provides a tentative appraisal of how public investors regard prevailing SSG features, given their rising influence over the reform agenda (Green, 2003). Three aspects of SSG structure are considered: the degree of ownership concentration, the presence of group affiliation, and the nature of ultimate controller. Two general conclusions emerge from these empirical results, which are broadly consistent with the qualitative findings. First, inside entrenchment and expropriation become more pronounced, as the economic and political jurisdiction of shareholding agencies, i.e. intermediate principals, has further expanded (Yeo, 2013). The beneficial effects of large shareholding should be considered within the broader context of SSG features, including the group structure and ultimate controller. Second, the statistical results confirm the proactive role of central policymakers in promoting effective SSG practices, as opposed to local bureaucracies. For Shirk (1993), the decentralized structure of China's political institutions gives rise to the different interests and motivations among central and local officials, and creates a richer set of potential outcomes. Beijing's renewed commitment to fostering a competitive and well-governed state sector has aided investors' quest for more effective protection. In this regard central government itself becomes a key player alongside emerging public investors in China's state sector reform. Indeed, without the administrative and regulatory push, progress in establishing more modern governance institutions would have faltered (Tam and Yu, 2011; see also Saich, 2011). It is reasonable to believe that further governance reform depends largely upon how central policymakers reconcile the espoused policy agenda with the actual interests of these emerging economic actors. Some (e.g. Saich, 2011; Lin and Milhaupt, 2013) would suggest that the governance practices arising from the changing political-economic landscape may not mount to a market-oriented system but instead resemble 'state corporatism'. As noted by Baum and Shevchenko (1999), the key attraction of this model is the state's ability to adjust and accommodate party-state control to the pluralizing socio-economic changes induced by market reforms. The significance of these initiatives and measures can be expected to produce a more "profound and far-reaching impact" on China's SSG system and practices (Tam and Yu, 2011, pp. 234; Lin and Milhaupt, 2013).

5.8 Summary

The chapter reviews the trajectory of China's state sector reform with special attention to the interplay between key stakeholders. It emphasizes that China's SSG is at a crucial new stage

where the focus is shifting from introducing “formal rules and regulations (over the 1990s) towards more comprehensive institution-building” aimed at protecting the interests of shareholders, including state and public investors (Tam and Yu, 2011. P. 224). Successive reforms have led to a state-dominated governance model relying upon regulatory and market coordination. Despite its still-pervasive influence, rigid central planning is no longer an option for central policy makers. Although ideological constraints and entrenched interests both impinged upon reform, these are not the only influential factors. In light of fading revolutionist ideology, the Chinese party-state has proactively sought to institutionalize its control amid increasingly market-oriented change. Increased marketization and administrative streamlining have re-shaped the respective interests and authority of ministries, localities and corporate managers. In the pursuit of these interests, the once unilateral and authoritative relationship between the government and enterprises has become more bilateral and contestable. The extant governance system and practices have often been exploited by local governments and quasi-administrative agencies to entrench their vested interests, giving other opportunities for management indiscretion and insider expropriation. As the influence of capital markets continues to grow, further SSG reform will largely hinge upon the institutional capacity to reconcile the state’s policy imperatives with investors’ quest for more effective protection.

State sector reform pursues both efficiency and legitimacy. Where policy makers are seeking financial resources necessary for restructuring the state sector, they need to ensure that the transparency and openness of the governance systems are sufficient to satisfy investors. How investors then judge emerging governance practices foreshadows further institutional evolution. This chapter also made a preliminary attempt to answer this question by examining the impacts of various SSG features upon stock market reactions to Chinese MNEs’ CM&A announcements. The statistical results confirm the preceding qualitative findings, in particular the positive role of central government in pursuing SSG reform. The combination of continued state control and incremental marketization could lead to more distinctive practices in Chinese SSG. In particular, the increased institutional openness associated with overseas listing implies multiple pressure points where prevailing governance shortcomings are open to changes that will need further empirical investigation (Djelic and Quack, 2007).

Chapter 6

State Sector Governance Reform at Individual Firm Level: The Case of China Life

6.1 Introduction

The previous chapter suggested that state sector governance (SSG) practices are not so much the outcomes of priori choices, but rather are shaped by wider social and political forces that determine institutional character and conduct. From a path-based perspective, SSG transformation should be a stated goal and progressive learning and adaptive process “whereby people, organizations and society as a whole unleash, strengthen, create, adapt and maintain capacity over time” (OECD, 2006, p. 53). This chapter presents a dynamic contextual analysis of the actual SSG development of an individual firm. It will elaborate upon its conduct and highlight the proactive role of change agents and other enabling conditions. By examining governance reforms in China Life – the world’s largest life insurer in terms of market capitalization – it will address the questions: (1) to what extent had China Life’s governance system and practices changed despite continued state control? (2) What are the results so far? (3) Who were the key reform actors and/or change agents? (4) How did they overcome the organizational and institutional obstacles encountered? This chapter proceeds with a review of the China Life’s historical development in Section 7.2. Section 7.3 introduces the governance system prior to its overseas listing. Sections 7.4-7.6 then examine the post-listing dynamics of China Life’s governance reforms in regard to interactions among key stakeholders and the socio-economic environment. The narrative covers the key institutional domains in which innovative governance practices emerged: capital markets, board mechanisms, and regulatory bodies. Section 7.7 finally summarizes the key research findings.

6.2 Historical Development of China Life

China Life formally dates back to the establishment of the People’s Insurance Company of China (PICC) by the State Council on October 20th 1949. While most pre-revolutionary insurers fled overseas and often re-established operations there, the state-operated insurance institute sought to integrate the remaining assets and expand into most Chinese provinces, autonomous regions and municipalities. After the national insurance sector had been nationalized, PICC monopolized all mainland insurance interests. By 1958, PICC had over

4,600 business branches and 50,000 employees. Meanwhile, the population participating in employee group and simple life insurance reached 3 million and 1.8 million respectively. The end of the First Five Year Plan (1953-1957) marked the accomplishment of the officially designated “transition to socialism”; commercial insurance was publicly considered contradictory to socialist ideology and superfluous in a socialist state that aimed to provide social welfare services “from cradle to grave”. During the Great Leap Forward and the People’s Commune Movement, the Work Conference on Finance and Trade of the State Council in 1958 proposed that: “after people’s commune system is established, insurance is no longer needed, and domestic insurance business shall be immediately suspended”. Thus, restrictions on the private ownership of property linked to wider political movements challenged concern for private insurance, culminating in the PICC's suspension of underwriting (Thomas, 2002). When insurance services were abolished in 1959, PICC had been further streamlined into a subordinate administrative department of the People’s Bank of China (PBOC), with a reduced role in the provision of overseas services, such as marine and aviation insurance support for state foreign policies (IN4, 2009).

The Third Plenary Session of the Eleventh Chinese Communist Party (CCP) Central Committee in April 1979 advocated the “resuming the domestic insurance business” as part of official efforts to re-invigorate the national economy. In November, the National Insurance Work Conference in Beijing officially restarted the domestic insurance business formerly suspended for more than 20 years. In 1979, PICC officially separated from PBOC, and resumed as an independently operated, state-controlled company under central bank supervision. In 1982, PICC began offering life insurance policies again, targeting small but growing numbers of middle-class and wealthy Chinese, including better-off farmers. As a state-owned monopolist, PICC became both supplier of property and life insurance, and regulator of all insurance activities. In the early 1990s, PICC’s gross insurance premiums even reached RMB 17.82 billion with an annual growth rate of 45.4 per cent compared to the 1980s (China Statistics Yearbook, 2004). Although life insurance was still insignificant in comparison to non-life insurance, the nominal growth rate of life insurance premiums during the second half of the same period exceeded 800 per cent, and market share reached 23.23 per cent in 1991 having been 0.16 per cent in 1982.

According to the 1995 Insurance Law, domestic insurers were required to specialize in particular market segments, and property and life insurance businesses operated separately afterward. As individual insurance companies could only provide one of these two, PICC

had been restructured into a holding company – PICC Group – with businesses transferred to three different subsidiaries: PICC Life Insurance, PICC Property Insurance, and PICC Reinsurance. As a prelude to corporatization, PICC Group and its subsidiaries duly became four independent business entities. By taking over existing life insurance business from the former PICC Life Insurance, China Life Insurance Company finally came into being in March 1999 as a solely state-owned enterprise.

In 2000, China Life announced planned ownership restructuring in preparation for future international listings. In June 2003, with the State Council and China Insurance Regulatory Commission's (CIRC) approval, China Life was further split into two business entities, the China Life Insurance Company Limited (China Life or the Company), and the China Life Group Company (the Group Company or the Group). On 17th and 18th December 2003, the Company launched initial public offering (IPOs) on both Hong Kong (HKSE) and New York Stock Exchanges (NYSE). This made it the first state-owned financial institution launching its overseas IPOs, raising US\$3.5 billion and becoming the world's largest IPO of the year. As the 2002 amended Insurance Law allowed a single insurance group to have both life insurance and property insurance subsidiaries, China Life expanded into new market sectors including property insurance, asset management and brokerage services. In 2003, China Life Asset Management Company was jointly founded by the Group Company and China Life. Under “the conglomeration strategy of being exceptionally strong in core businesses and appropriately diversified in operation”, another two subsidiaries, i.e. China Life Property and Casualty Insurance Company and China Life Pension Company, were successively established in 2006 (IN6, 2010). By the late 2009, China Life's market capitalization totalled US\$ 54.22 billion, putting it ahead of major international competitors, i.e. AIG and AXA. China Life thus became the world's largest life insurer in terms of market capitalization.

6.3 Governance System of China Life Prior to Overseas Listing (1949-2000)

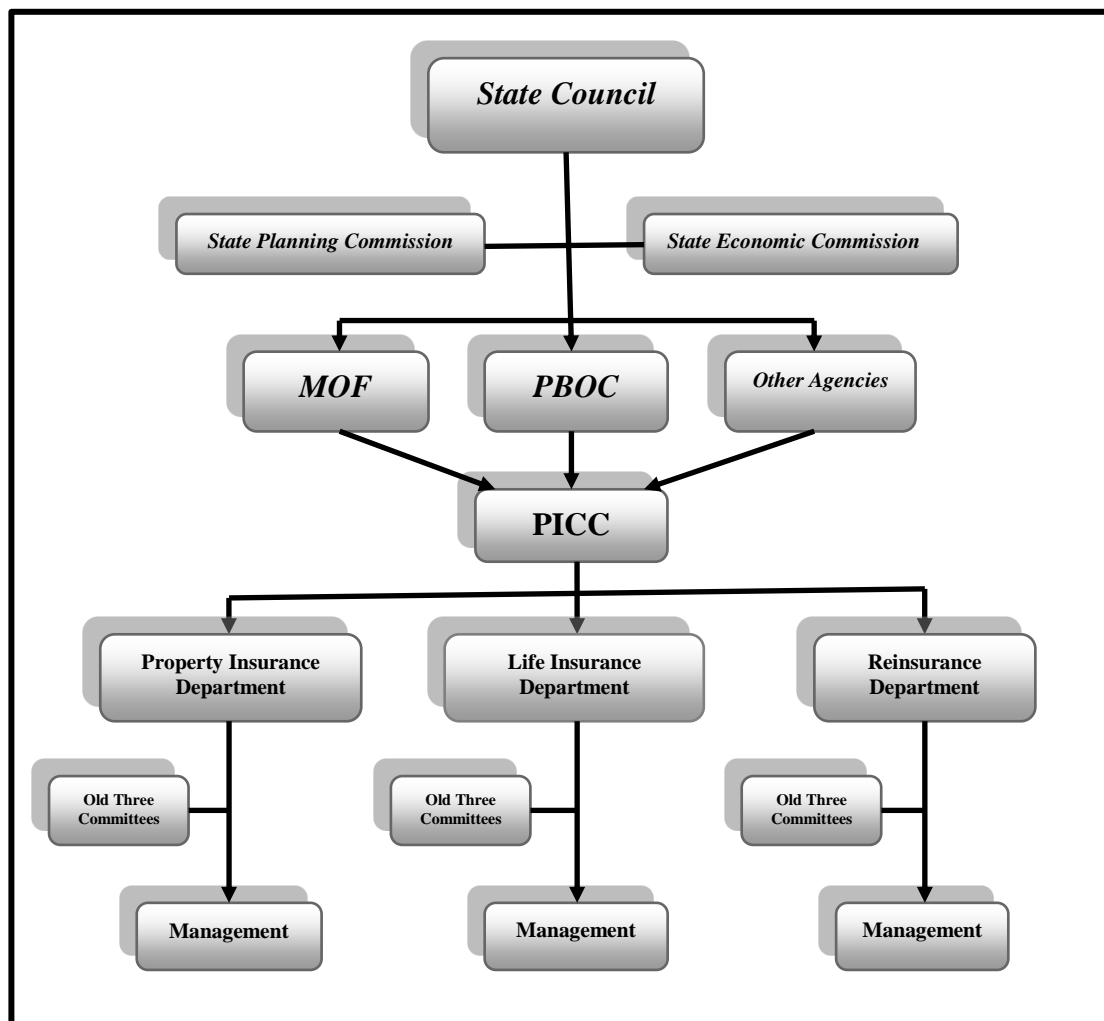
Over the centrally-planned era, PICC was designated as an administrative unit (*xingzheng danwei* in Chinese) under the direct leadership and supervision of PBOC and the Ministry of Finance (MOF). Meanwhile the State Planning Commission (SPC) and State Economic Commission (SEC) assumed a leading role in directing and administrating the financial sector. Thus the governance system of PICC was essentially embedded within the extensive bureaucratic infrastructure of the state. Figure 6.1 depicts the governance framework of PICC under the centrally-planning system.

6.3.1 Governance Structure

The governance structure of PICC largely mirrored those of state-run units (SRUs): enterprise management and daily operation relied upon the “old three committees”, i.e. the party committee, labour union and employee representative committee. Where most economic and sales parameters were arbitrarily determined by different ministries and planning commissions, the party committees assumed the leading role in implementing superior directives and conducting ideological indoctrination. The party’s *nomenklatura*, i.e. the Central Committee of the CCP, acted as the headquarters of numerous party cells at the intermediary and grass-root layers, retaining the ultimate authority over the promotion and dismissal of enterprise managers and/or state cadres. For Schurmann (1966, p. 1) communist China could then be conceived as a politically and ideologically constructed society which was “like a vast building made of different kinds of brick and stone”, and what held this building together was bureaucracy and ideology. Political correctness and/or party membership constituted the major criteria for managerial evaluation and supervision. They were necessary for most managerial positions and thus conferred significant advantages (IN4, 2009). For central planners, an indispensable ideological ingredient served as a substitute for scarce capital and backward technology (Oksenberg and Tong, 1991). Two retired managers of PICC here elaborated:

- *“The party committees existed at almost all levels of enterprise operation, from the centre to the township units. The committee members evaluated the staff according to their performance in political activities (zhengzhi huodong biao xian in Chinese), including the study of Marxism and Maoism, as well as the guidelines from the planning commissions. The backward elements (luohou fenzi in Chinese) would be deprived of the changes of career promotion. Since remuneration was based on administrative rankings, this was the only viable way to discipline state cadres”* (IN5, 2012);
- *“Unlike industrial SRUs, (state-owned) financial institutions did not require much technical expertise. Thus, the secretary of a party committee often combined the role of a branch or department manager. The appointment, evaluation and removal of managers were determined by the party committee members based on their political performance, in particular, whether they had carried out the guidelines imposed by the superior agencies”* (IN22, 2010).

Figure 6.1 Governance Structure of PICC Prior to the 1980s



In this way, the combination of bureaucratic hierarchy and ideological conformity penetrated and governed every dimension of the enterprise operation. Alike the imperial past, the CCP had once again brought a political system that relied upon strict bureaucratic hierarchy, this time in the form of the *nomenklatura* system integrated with the once pervasive ideologies of Marxism and Maoism. Although Confucianism and Communism sustained their distinctive belief in hierarchical order and state-society relationships, both appeared remarkably monolithic, with political action centred upon the directives from top leadership. For Pye (1992, pp. 11-16), both the imperial bureaucracies and the CCP explicitly stressed the importance of authority and order in procedural practices and ideological cultivation. Thus, enterprise governance became a self-contained system with little influence from grassroots employees and/or other non-party elites; enterprise managers or state cadres had little concern to keep higher governmental authority in check (Pye, 1992, pp. 11-16, p. 25).

Unsurprisingly the role of workers' participation in enterprise governance had been subordinated to high profile party committee members (see also Morris et al., 2002). Although the principle of "democratic management by workers" entered the Chinese Constitution, it did not articulate how labour unions and employee representative committees at all levels were subordinate affiliates of party committees (IN5, 2012). Union officials and representatives often need the authority of party bureaucracies to attain their own agenda, including the appointment of union leaders (Xi, 2006). Labour union and employee representative committees generally adopted the role of mass adjunct to the party-state apparatus and functioned as surveillance organs and transmission belts for internal stability and promoting the CCP's ideological goals (see Kornai, 1992, pp. 219). At times of tight political control and production-mobilization campaigns, they often sided with the CCP's bureaucrats to push through top-down industrial policies and political movements (Chan, 1993). The dual functions of safeguarding workers' rights and being surveillance organs often led to ambivalence. In striving to channel employees' discontent, representatives had to satisfy their superiors by suppressing alternative voices, thereby making their allegiance evident. As one former union official commented, "while the party committee was responsible for evaluating and monitoring the state cadres, the company's labour union was merely another party committee for supervising grassroots employees" (IN3, 2010). Such practices remained largely intact over the pre-restructuring era, though they contrasted significantly with the CCP's long-cherished concept of workers' political status as "the masters of the enterprises".¹

The expansion of market mechanisms further eroded employee involvement. Although managerial remuneration remained largely undifferentiated, "expanding market shares was often imposed as a political task of commanding height" (IN22, 2010). In this process the role of the labour union and the employee representative committee in balancing corporate management was minimized.² The following statements reveal the lack of a necessary power base and relevant expertise to continue due oversight:

- *"In most cases, these union officials and employees' representatives were the senior cadres in the grassroots units. Their work focus was to advance employees' welfare; their*

¹ Under the rhetoric terms of socialism ideology that "workers are the masters of enterprises", appointing employees' representative as the supervisors became the new form of workers' participation in the enterprise management.

² In other SRUs, the workers' protest arising from enterprise restructuring frequently appeared even in the state media. This reflects employees' strong opposition to governance practices process that excluded their participation, ignored their interests, and infringed their rights.

expertise was employees' mobilization rather than business management and sales expansion. Many of them were unable to understand the operation of an insurance company" (IN5, 2011);

- *"Moreover, most of the representatives themselves were serving in middle-level management positions. In this case, they were subordinate to the senior managers and members of the party committees. This joint posting caused interest conflicts and thus prevented them from overseeing enterprise management"* (IN4, 2009);
- *"The role of employees' representative became rather symbolic"* (IN1, 2009).

With the shifting emphasis towards sales growth, the traditional political goals pursued by party bureaucracies also became increasingly questionable. During interviews, informants often claimed that party committee members generally lacked the business expertise necessary for due oversight. This led party bureaucracies to identify themselves with enterprise managers. A former secretary of a provincial party committee here noted:

"The party committee had its advantage in mobilizing the masses and implementing political education. However, as to sales expansion, it lacked the necessary expertise. In this case, we could only play a supportive role for the sales staff. Evaluation of managers and/or cadres was based on whether they met sales targets. Party members knew little about the procedure of selling insurance policies, not to mention the inherent risk. They could only rely upon the numbers in the receipts presented by the managers... what we could do was to support their sales activities and repeatedly check sales expansion. Political education became secondary" (IN15, 2011).

Indeed party committee members confided to oversee the implementation of "political study campaigns" (*zhnegzhi xuexi yundong* in Chinese). For managers, these political activities simply "wasted their precious time for increasing premium sales" (IN14, 2010; IN18, 2011). In many cases cadres of the party committees repeatedly complained that the task of implementing political initiatives were widely disliked (IN15, 2011). The prominence of egalitarianism and compliancism thus became increasingly incompatible with the competitive pressure from market deregulation.

6.3.2 Managerial Tasks and Incentives

Like other state-run units, PICC adopted a highly centralized eight-grade remuneration system with seniority-based rankings (IN5, 2010). Due to direct fiscal grants from central government, PICC provided lifetime employment with welfare coverage ‘from cradle to grave’. The following statements suggested that these practices should be examined within the broader social-economic context:

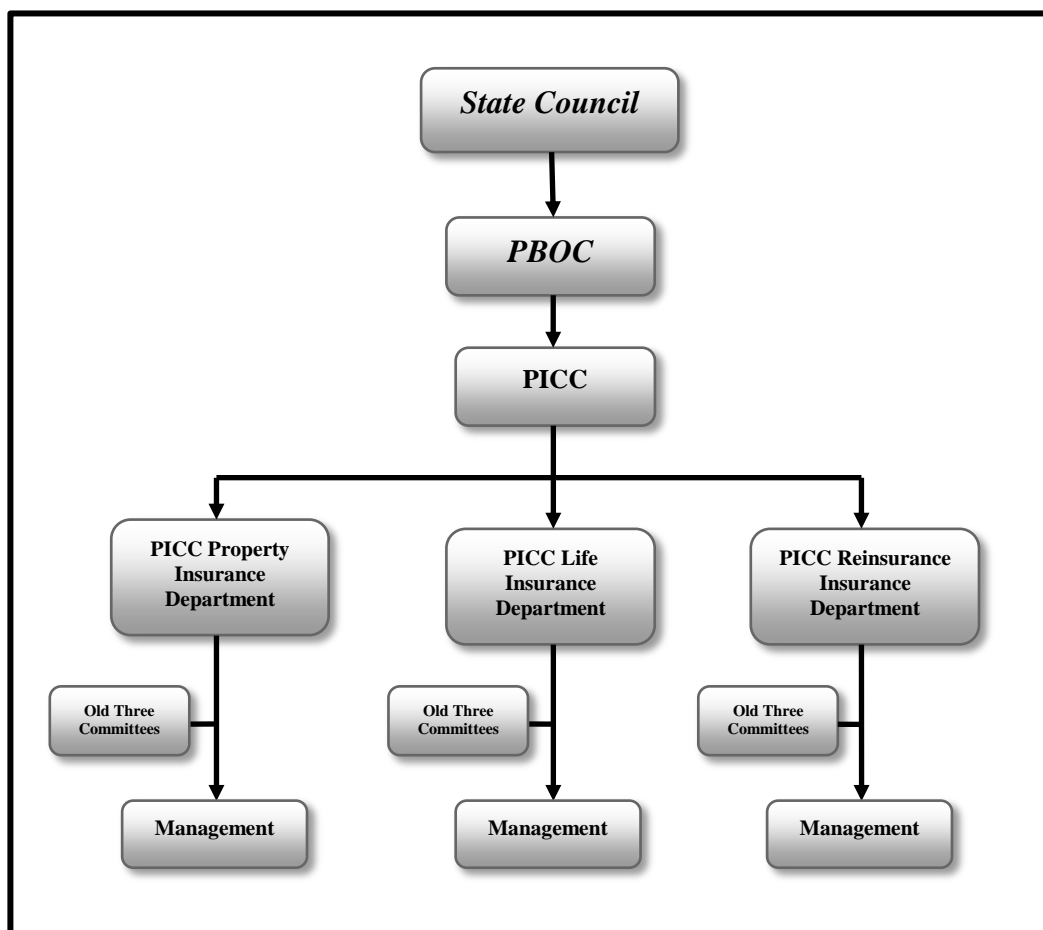
- *“The staff’s remuneration was basically determined by their administrative rankings. This was the same with other state-run units and administrative apparatus. The financial sector in the centrally planned era supported industrialization. It was more like a financial or accounting department in a giant state-owned factory. Thus there was no reason why its remuneration should differ from others”* (IN5, 2010);
- *“If someone was lucky enough to be allocated work in a state-run unit, that means that not only he or she, but also the whole family would benefit from the welfare provided by the state. At that time, this was the main motivation for us to work in PICC”* (IN4, 2009);
- *“The end of cultural revolution brought lots of young people who used to work in the rural areas back to the city. The state-run units became the main organs to absorb the radical increase in labour force. Every month, my department was assigned quotas to recruit these young people. The welfare benefits clearly attracted lots of them”* (IN22, 2012).

As noted, the job security and other welfare benefits underwritten by the bureaucratic apparatus were important political assets for the ruling party to assert the superiority of a socialist state. For Wu (2005), such a paternalist labour regime was also the key to maintaining the administrative order throughout the centrally planned era (Chen, 2003). As productivity and other financial objectives had little influence upon managers’ remuneration and promotion, their primary task was to execute a complex repertoire of financial and administrative directives imposed by the superiors (IN4, 2009). One senior executive vividly illustrated this thus:

“In the summer of 1980, I was given the task of promoting the first property insurance products aimed at the rural masses. I had to communicate with county and village governments prior to my arrival, and asked their help to mobilize the masses. I spent the

whole week in a town and managed to sell only one insurance policy. However, I was highly praised by my managers as I had successfully fulfilled the task of ‘helping our peasant brotherhood’” (IN20, 2011).

Figure 6.2 Governance Structure of PICC during the 1980s



In 1979, PICC was officially separated from PBOC and resumed as an independently operated, state-controlled company under PBOC’s direct supervision. Figure 6.2 illustrates its changed organizational structure. Although the industrial sector embarked upon reforms with the main theme of power delegation and profit sharing, state-owned financial institutions remained under the rigid control of central planners (IN7, 2011). For hard-line conservatives, the financial sector represented such a vast patronage system that they were reluctant to relinquish control (Pei, 2009; McGregor, 2010). Former senior managers in PICC here explained:

- *“Historically, senior executives in PICC consisted mainly of personnel appointed by different planning commissions in the central government. Some prominent hard-line central planners, such as Chen Yun and Bo Yibo, were politburo members who directly*

supervised state-owned financial institutions. Provincial branches of PBOC were responsible for supervising and monitoring the operation of PICC's business units at different levels" (IN4, 2009);

- *"Senior officials in PBOC and other ministries often help their children to find jobs in state-owned financial institutions. As relational factors often help them achieve relatively high administrative rankings, they were the main beneficiaries of the seniority-based system. They were strongly opposed to the introduction of market-oriented remuneration" (IN19, 2010).*

Nevertheless, market transition created new opportunities for the domestic insurer. In particular, rising income levels, demands for higher life quality, and a more market-oriented social security system all increased demand for life insurance policies. In 1982, PICC began offering life insurance policies again, targeting small but growing number of middle-class and wealthy Chinese, including better-off farmers. Although PICC's gross life insurance premiums totalled only RMB 1.6 million in 1986, both the non-life and life insurance markets then grew significantly, with respective growth rates exceeding the national GDP growth rate. However, a significant share of insurance policy sales continued to be planned, with policy-oriented insurance products (*zhengce xing baoxian* in Chinese) having priority over those serving private needs (IN11, 2010).

Although the company progressively shifted its focus towards premium growth, remuneration of managers remained determined by the administrative rankings until the mid-1990s (IN15, 2010). General managers of the headquarter and provincial branches were categorised as senior state cadres, and thus entitled to significant perks and prestige compared with managers at the grass-root level. The bureaucratic-centred governance structure indicated that the managers were hardly self-motivated economic agents when they were still obliged to enforce the premium-growth targets imposed by the central bank. Even if rigid sales targets were eliminated, they were subsequently replaced by more flexible (yet also more unpredictable) directives rather than genuine market indicators (IN26, 2010). This compelled managers to constantly bargain with administrative superiors for preferential financial treatments and sales quotas (IN15, 2010).

In the mid-1990s PICC introduced a bonus scheme to "improve managerial incentives and stimulate premium growth" with increasing decision-making rights delegated to branch

and/or department managers, (IN19, 2011). However, the absence of real ownership stakes left the asymmetric relationship between power and responsibility largely unaddressed (Tenev and Zhang, 2002). Thus, changes in incentive structure simply increased the likelihood of pursuing managerial self-interest at others' expense. It appeared that, ever since the centrally planned period, managerial privileges were not only based on salaries and bonuses, but also on sizeable perks, including better and larger apartments, private use of cars, "corporate accounts" for business lunches and dinners, entertainment, domestic touring and suchlike (see also Qian and Stiglitz 1996). A senior managerial position then often entailed distinguishable and non-explicit discretion over substantial quasi-rents. This was particularly so for large-scaled enterprises which operated in those industrial sectors designated as of "commanding height". The increased managerial autonomy provoked certain enterprise cadres to abuse their power over remuneration and exercise favouritism. While such malpractice might bring significant financial loss, the higher directors, who considered themselves politically-motivated party bureaucrats, lacked the ability and incentives to conduct due managerial oversight and risk assessment, so that penalties for poor performing managers were largely softened. Moreover, the absence of a genuine system of accountability meant that enterprise managers at all levels were in a unique position to turn professional work relationships into personal connections for rent-seeking activities (see also Saich, 2011, p. 141). A sales manager of PICC's Guangdong branch here acknowledged the prevalence of related malpractices over the 1990s thus:

"In the past, the receipt of an insurance policy normally consisted of two parts – one was for the policy holder, the other for the company. Before the computer record system was introduced, receipts were all written by the accounting staff. You just needed to write down two different amounts respectively. The one with the smaller amount was given to the company; the other one with the bigger amount which was the actual amount insured was kept by the client. Any difference could then be kept by the sales staff... Of course, you had to share the 'rent' with the accounting staff and your department manager and even the branch director, so that they would just 'open one eye and close one eye'. 'Dragging them into the water' would help to gain their tacit permission. This was so prevalent that we all knew that was 'the implicit rules of the game'. As the premium growth became the priority for the bureaucrats, who would actually care about the inherent problems?" (IN14, 2010).

6.3.3 Regulatory Reform and Administrative Streamlining

In contrast to the stagnant enterprise reform, the deepening of market deregulation induced several structural transformations, which would in turn call for regulatory reform. In 1988, the establishment of Ping An Insurance Company (Ping An) and China Pacific Insurance Company (China Pacific) signalled the disruption of the state monopoly in the domestic insurance sector. The former grew into the second largest life insurer in the mainland market and, once the American International Group (AIG) was licensed to operate its self-standing business branches in 1992, domestic insurance opened to foreign companies for the first time since the end of the civil war. Thus further specialization and wider regional fragmentation in the mainland insurance market challenged PICC's combined role as both the supplier and regulator of insurance services.

In 1995 the National People's Congress (NPC) promulgated China's first Insurance Law as a major step in establishing a comprehensive framework for regulating the domestic insurance market. Observers then noted that the law was "a very good start in the implementing of an internationally acceptable standard of insurance regulation", and that it would "lay a firm foundation for a healthy insurance environment" (Thomas, 2002, p. 418). In 1998, the supervisory and regulatory arm of the mainland insurance industry was transferred to a newly formed regulatory agency, i.e. CIRC, from PBOC. The specialist agency, which aspired to wider international standards, was expected to further enhance the state's regulatory capacities over the fast-growing industry (IN26, 2010). Under the Insurance Law, this semi-ministerial institution has been empowered to:

- Formulate policies, strategies and plans regarding insurance industry development;
- Examine and approve the qualifications of senior managers in all insurance-related organizations;
- Supervise the solvency and market conduct of individual insurance companies;
- Supervise the business operation of public-policy-oriented insurance and statutory insurance;
- Investigate irregularities such as unfair competition by insurance organizations and practitioners and direct engagement or disguised engagement in insurance business by non-insurance organizations, and impose penalties accordingly;
- Establish due risk-assessment, risk-warning and risk-monitoring systems.

As noted by Thomas (2002), CIRC had broad enough powers to investigate violations of the Insurance Law. Insurers were likewise required to submit monthly statistical reports and annual reports to the regulator. In addition, CIRC was authorized to inspect the business, financial and capital conditions of insurers and to require additional written reports or information. Agents and brokers were also subject to these inspection and reporting requirements.³

Accelerated regulatory restructuring enabled governance reform to be continued; corporate restructuring was designed to distance enterprises from government interventions. China Life had been converted formally from an administrative subordinate of PBOC to an independent business entity. This was expected to alleviate the mounting fiscal burden of central government as corporatized SRUs assumed the sole responsibility for profit and loss (IN3, 2010; IN2, 2011). Meanwhile, it also allowed China Life to “focus on business operation and further enhance its competitiveness” (IN26, 2009). Following China’s WTO entry in late 2001, China’s insurance market has become one of the most open financial sectors. According to the timetable for China’s WTO accession, most restrictions on ownership, business scope and geographical areas were to be abolished by late 2004. Successive corporate restructurings over the late-1990s reflected the new regulator’s ambition of “forging a globally competitive insurer” (IN26, 2009). A number of senior officials concluded that, without the strong disciplinary power of external mechanisms, enterprise reform might grind to a halt as vested interests would then resist further forward momentum (IN28; 2010; IN29, 2010; IN26, 2011; IN27, 2011; see also Saich, 2012). In essence, there was little in the WTO agreements that hindered the central policy makers’ stated desire to establish more effective governance institutions, in particular in the financial and other monopolistic industrial sectors (IN26, 2011). As elaborated by the former senior executive from PICC:

“The fact that the fiscal income contributed by the insurer had been traditionally smaller than the banking industry meant that reform oppositions from the conservatives would be less fierce. Moreover, (financial) problems in PICC were less mounting and difficult than in the state-owned banks. One thing for sure was that the establishment of new regulator had

³ Although sales and claims practices were not explicitly subject to CIRC’s discretion, the statutory requirements are sufficiently vague to give CIRC a significant amount of room to interpret them. For example, the statute requires that insurance must be entered on a “fair, voluntary and mutually beneficial basis”, and that insurance contracts could not “infringe upon the public interest”. CIRC had the right to interpret what was “fair” or in the “public interest” (see Thomas, 2002).

greatly alleviated the opposition from PBOC. The regulatory reform and choosing PICC as the breakpoint of restructuring the state-owned financial institutions greatly reduced the reform difficulty. To a certain extent, this was a political choice” (IN5, 2010).

Summing up, China Life’s governance system over the re-restructuring era reflected the legacy of administrative planning. With the highly stylised enterprise hierarchy, bureaucratic intervention was designed to advance political rather than economic objectives, thus distorting managerial incentives. The inherent self-destructive effects were reflected by inefficient monitoring and the prevalence of fraud and corruption. The decline of centralized planning was due not only to the rigidity and disincentives under stratified control, but also to the corrosive effects of managers’ rent-seeking behaviour. Although the vested interests and monopoly practices constituted formidable adversaries to governance reform, rising competitive pressure and growing regulatory complexity provoked successive legislative reforms and the fundamental transit of regulatory functions. In addition to governance defects revealed, pressures from economic globalization, in particular China’s WTO entry, created a powerful rationale for more comprehensive restructuring – building a globally competitive state insurer became “a matter of national interests” for the central policy makers (IN29, 2011). The abolition of PBOC’s oversight function weakened the once-insurmountable power of entrenched bureaucracies, thus preparing the ground for subsequent corporate restructuring.

6.4 Restructuring, Board Institutions and Overseas Listing (2000-2004)

In 2000, China Life encompassed corporate restructuring as part of continuous efforts at enlarging enterprise autonomy. Ownership diversification, together with more basic steps at “establishing modern enterprise institutions” (*jianli xiandai qiye zhidu* in Chinese), were intended to reduce government intervention from enterprise management, and thus hold China Life more accountable for its profit and loss (IN5, 2010; IN9, 2010; see Sun and Tobin, 2005; Sun and Hong, 2006). It is envisioned that expanded capital base and improved governance system would serve to transform the domestic insurer into a globally competitive brand (CIRC, 2001; Cao, 2005; IN4, 2009; IN9, 2010). Nevertheless, the concern for policy makers before then was the imminent danger of insolvency given the size of spread loss. Thus much reform effort, including “caving out the non-performing assets” (*boli buliang zichan* in Chinese) and related fiscal arrangements, centred on the resolution of potential capital shortage. On the other hand, effectiveness of corporate restructuring depends both on

the organisational set-up upstream, i.e. the streamlining of administrative apparatus and development regulatory framework in the Chinese case, and on the actual function and practices of governance mechanisms (OECD, 2005b). Ownership diversification has clarified central government as *de jure* owner but here allowed the Group Company to retain its ownership control and influence over the corporate agenda. Politics among self-interested insiders thus mediated the efficacy of transplanted governance institutions. In this regard much remained to be accomplished in firm-level institutional building.

6.4.1 Capital Shortage and Corporate Restructuring

China Life's capital shortage was largely due to the mounting spread of losses from insurance policies with high guaranteed rates of return. Spread loss occurs when the investment return rate of insurance premium becomes less than the assumed interest rate already embedded in mid- or long-term insurance policies. In a typical scenario of spread loss, insurers find it increasingly difficult to gain investment returns greater than returns guaranteed due to declining interest rates. As investment returns become compressed, these insurance products tend to cause spread losses that further undermine corporate solvency. The insolvency issue might then deteriorate so seriously that the insurers eventually go bankrupt (see Yao et al., 2005).

A leading example was the successive bankruptcy of Japanese life insurers over the late 1980s. With fast-paced growth, Japan's Ministry of Finance grew concerned about prospective inflation rate, and accordingly, tightened money supply by raising interest rates. Insurers then responded to successive interest rate hikes by continuously raising their own assumed interest rates to a peak of 6.25 per cent. As economic growth faltered in 1991, asset deflation, rising unemployment rates, and falling corporate profitability and shrinking investment activities followed. Between 1996 and 2005, the collapse of Japan's asset-inflated "bubble" economy led to a period of extremely low interest rates and stagnating stock prices. Japan's life insurance companies saw their own financial situations deteriorate rapidly as their asset investments fell short of the guaranteed yields already promised to their policyholders. Since 1991, severe spread losses occurred among almost all life insurance companies, and ultimately caused the bankruptcies of major large insurers from 1997 to 2000, including Nissan Life Insurance, Chiyoda Life Insurance, and Kyoei Life Insurance.

The spread loss encountered by China Life had its own particular political-economic origins.

Over the early 1990s, artificially low interest rates were adopted as a major policy tool to stimulate stagnant domestic demand and industrial investment. In this context, insurance products with high guaranteed rates of return had been applied by the grass-root business units as the major means to stimulate premium growth and expand market shares. Between 1993 and 1997, premium income derived from those high yield insurance products (above 7.5 per cent) totalled more than RMB 80 billion. However, investment overheats and redundant production capacity had already brought interest rate reductions to curb high inflation. Therefore, investment return rates for China's life insurance companies went into persistent decline and fell to a record low of 3.4 per cent in 2003 (IN26; 2011; IN27; 2011). Interviews with two senior officials of CIRC conveyed the great concerns of central policy makers:

- *“Under the Hong Kong Accounting Standards, China Life's net loss in 2002 was estimated to reach RMB 2.25 billion, mostly attributed to the huge amount of negative spread. Although the assumed interest rate of the subsequent long-term insurance policies has been reduced to a much lower level of 2.5 per cent since 2004, the financial risk derived from the still-growing spread loss significantly impaired the Company's competitiveness”* (IN29, 2010);
- *“China Life is the flagship of our country's insurance industry. The Company's success or failure matters not only for the fate of thousands of its employees, but also the sound development of China's insurance industry. An insurance company with questionable solvency would be impossible to compete with their international counterparts when mainland insurance is entirely opened for foreign insurers”* (IN26, 2009).

Officials from the regulatory body often attributed the spread loss to wider monetary policy changes. Other responses provided by the managers of provincial branches revealed that the problem was also deeply rooted within the poor governance practices. Commonly expressed statements by several senior marketing managers in Guangdong provincial branches indicated that ill-defined incentive schemes and the absence of a real owner were regarded as the root causes:

- *“Since the mid-1990s, Guangdong has been the earliest regional insurance market opened to foreign competition. The provincial headquarter and local branches faced furious market competition with the non-state insurers. ‘Fighting for the market, competing for*

the share' had become the chief business goal. In this case, the remuneration of sales staff and executives started to be closely bound to the premium growth" (IN13, 2010);

- *"‘Premium First’ had actually become the slogan of our sales teams. However, profitability and other risk factors of various insurance products had basically been neglected" (IN14, 2010);*
- *"The branch's sales staffs were generally unaware of the risk characteristics of the (insurance) industry, or they did not care about them at all. A simple and the most fundamental reason was that China Life was solely state-owned. This meant that whenever there were troubles, they would definitely be taken care of and solved by the state" (IN11, 2010).*

As noted, an over-emphasis on premium growth had unexpectedly given rise to short-termism in firm performance. As the negotiations of sales targets were conducted annually, there was tendency for managers to concentrate primarily on the basic quantitative parameters while neglecting the inherent risk and the enterprise's long-term strategy. The asymmetry between power and responsibilities provoked grassroots sales staff to pursue their private interests at the expense of the state. The resultant managerial malpractices and business corruption would further jeopardize the financial soundness of the company. While rent-seekers often captured the economic benefits, the ultimate bearer of cost and risk could only be the state.

In preparation for overseas listing, central policymakers have received several different proposals regarding the restructuring of non-performing assets since early 2001. The complexity and uncertainty of corporate restructuring suggested that it was unwise to pursue many political objectives at the same time (IN1, 2009, 2010; IN3, 2010). Where the task of addressing mounting spread losses and preventing the potential insolvency appeared the most urgent, the State Council faced difficulty in accommodating divergent interests within its bureaucratic apparatus. On the one hand, continuous subsidies to loss making SOEs drained significant financial resources. In this case, a large injection of capital would inevitably aggravate fiscal burdens and thus the proposal encountered strong oppositions from the MOF. In fact, the MOF preferred to accept proposals by Goldman Sachs, which advocated increasing the proportion of insurance policies with high profit margins over the longer term (IN9, 2010). However, CIRC expressed concern that a loss-making state-owned

insurance giant doubted its vision of “fostering a world-class insurance company”. As noted by one senior CRIC official: “by the time the spread loss problem was addressed, the Company may have already been in a disadvantageous position compared with the newly-entered foreign insurers” (IN28, 2010).

To align different reform visions, central policymakers devised a “spin-off” scheme drawn from banking reform. With “Chinese Heat” in foreign stock markets, policymakers hoped that a radical improvement in asset quality could help China Life pick the best IPO timing for raising external capital.⁴ Like other banking restructuring schemes, this spin-off scheme paralleled a series of administrative reorganizations. As a result, premium assets consisting mainly of long and medium-term insurance policies issued after June 10th 1999 were diverted to the soon to-be-listed business entity, i.e. China Life Insurance Company Limited.⁵ Meanwhile, the carved-out parent company, i.e. China Life Shareholding Group, took over the remaining loss-making policies issued at high-assumed interest rates amounting to US\$ 6.38 million.⁶ With the State Council’s approval, an investment fund co-managed by the Group Company and MOF had been established to fulfil the payment of spun-off insurance policies. The fund was designated to guarantee sufficient capital inflow to address the spread loss problem. Its capital sources consisted mainly of: (1) insurance premiums of the renewed taken-over insurance policies; (2) refunded tax payments from the MOF; (3) remitted dividends from the listed insurance company; and (4) income from the liquidation of non-tradable shares. The restructuring of China Life initiated in 2001 was finally accomplished in September 2003. EuroMoney Magazine commented that the spin-off scheme was the best restructuring design of the Year. The former BOD secretary further commented about the success of the spin-off programme:

⁴ A senior executive revealed some details that were unknown by the public before regard to the selection of stock-listing proposal:

“According to the original (listing) plan, the introduction of non-state strategic investors via private placement should have proceeded prior to the overseas listing. The equity participation allowed the strategic investors to take hand of the corporate operation and management. This in turn would have introduced new management approaches, better incentive systems and thus improved the corporate governance level of China Life before its listing. This becomes the most generally used method in the later restructuring of the state’s banking sector... However, the time-consuming characteristic of this method would have caused the Company to miss the best opportunity for the overseas listing. As we know, the China Concept Shares were one of the most favoured investment choices by foreign investors during the time. The limited capital raised via stock listing would have in turn impaired the resolving of spread loss. In this case, the State Council and CIRC decided to accelerate the IPO process so that China Life would set an example for the reform of China’s financial sector” (IN9, 2010).

⁵ These include all the assets and debt deriving from those unexpired main insurance contracts, their attached contracts, and other reinsurance contracts, which were approved by CIRC since the June of 1999.

⁶ The number is from a restricted document issued during a senior executives’ meeting on June 30 2003.

“According to the actuaries’ estimation, the insurance premium from the taken-over insurance policies’ renewal, together with the income from asset sales and our investment returns would be enough to cover the annual insurance claims of these old insurance policies before 2023. After 2023, the capital gap could be filled in with refunded tax payments from MOF and dividend payments from the listed company” (IN5, 2010).

For the central policymakers, the programme did not work in the sense of clearing up the non-performing asset, but it did postpone the insolvency risk until China Life’s financial condition was healthier.

6.4.2 Board Institutions and Insider Control

Modern corporate governance (CG) institutions were formally introduced alongside administrative streamlining, as depicted by Figure 6.3. Following Company Law, China Life adopted a dual-board system for internal corporate control, with the board of directors (BOD or the Board) responsible for major decision-making. The central policy makers sought to transform China Life into “a truly independence business entity which is responsible for its own profit and loss” (IN3, 2010; IN2, 2011). A survey conducted by the Shanghai Stock Exchange in early 2000 suggested that the top three shareholders of mainland listed companies controlled on average 59.0 per cent of shareholdings while appointing 79.0 per cent of directors. Such a disparity suggested that various shareholding agencies were often decisive in general shareholders’ meetings. By early 2007 when China Life’s A-Share IPO was launched, these shareholding agencies controlled on average 70.0 per cent of board seats on the mainland listed companies through direct or indirect means (Wan and Gelsi, 2003).

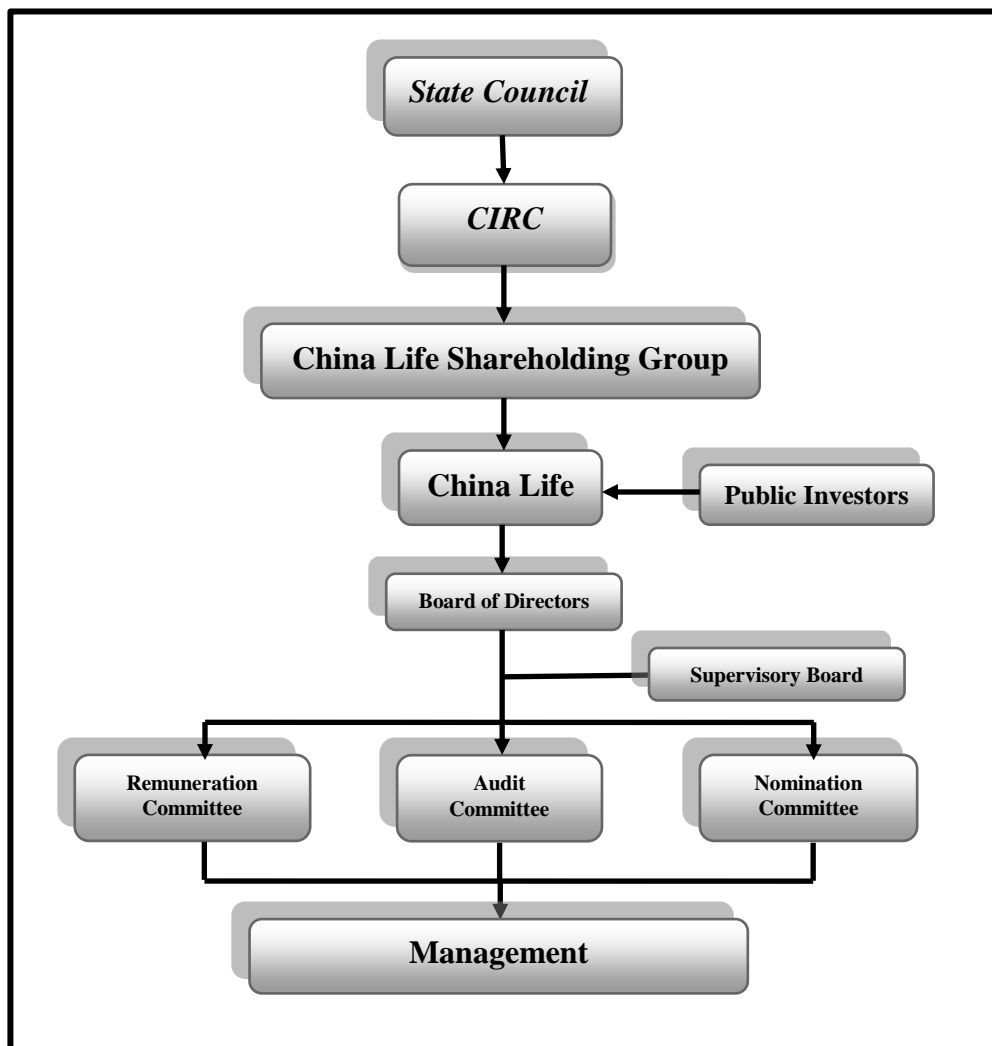
According to China Life’s annual reports, the Group Company had controlled, on average, 69.7 per cent of the total share capital of China Life since its overseas IPO; this was significantly higher than its domestic counterpart Ping An, with 14.5 per cent. Despite the structural changes, the primacy of hierarchical controls has largely been preserved through corporatization (IN1, 2010; IN26; 2011; IN27; 2011). The following statements of several senior executives from both the Group and listed companies have exemplified such a legacy of superior-subordinate relationships:

- “The role of the Group Company is to represent the state – the ultimate and the real owner of the state asset – to supervise and manage the listed company. As the main equity

provider, we certainly need to control the enterprise management and personnel appointment in China Life” (IN1, 2009);

- “However, the Group Company should not be interpreted merely as a shareholding agency. It is a semi-administrative, semi-business institute through which the state exercises its control” (IN15, 2010).

Figure 6.3 Governance Structure of China Life after Restructuring



Afflicted by the spread loss burden and other administrative functions, the Group Company was perceived to be the least reformed and marketized entity (see also Naughton, 2008). The reformist leadership allowed the perpetuation of “administrative treatments” (*xingzheng daiyu* in Chinese) to neutralize the opposition from the entrenched interests. As the Group Company senior executives elaborated:

- “The Group Company ... plays its role as the autonomous shareholding agency. In fact,

its main duty was to take over the burden of spun-off assets and administrative functions of the PICC. The restructuring inevitably caused many incumbent staff to be laid off. The Group Company could absorb the negative impact and reduce oppositions against corporate restructuring” (IN9, 2010);

- *“Staffs in the Group Company often were still within the welfare system of the Service Units and the Enterprise Social Organization (shiye danwei in Chinese)... In this case, they often required persistent welfare subsidiaries, including housing benefits and transportation reimbursements, in exchange for taking over the non-performing assets...Issues regarding profit remittance made the relationship between the listed and parent companies traditionally tense” (IN22, 2010).*

Under the highly concentrated ownership, directors selected by the shareholding agency often dominate the board of directors of the listed company. By the end of 2012, more than 60 per cent of the directors have served as the “leading team members” of the Group Company (China Life, 2003, 2004, and 2012). Tables 6.1a – 6.1c present the directors' biographies, with members of the “leading team” highlighted. In “the absence of real owners or principals”, executive directors and other senior executives usually become de facto controllers of the Company. They have powers of control, execution, and supervision, and thus become the ultimate decision-making body in corporate affairs (see also Nakamura, 2008). They can act as sole representatives of the controlling shareholder, with little regard for minority shareholder rights (IN1, 2010; IN4, 2011).

Table 6.1a Biographical Backgrounds of China Life’s Board Members (2003)⁷

Directors	Positions in the Board	Other and Previous Positions
Wang Xianzhang	Chairman of the Board and President	Former General Manager of PICC, President and Secretary of the CCP Committee of the Group Company
Miao Fuchun	Director and Vice President	Vice President and Member of the CCP Committee of the Group Company
Wu Yan	Non-Executive Director	Vice President and Member of the CCP Committee of the Group Company
Long Yongtu	Independent Non-Executive Director	Vice Minister of the Ministry of Commerce
Chau Tak Hay	Independent Non-Executive Director	Special Consultant of the Ministry of Commerce

Source: China Life 2003 Annual Report and Interviews

⁷ The highlighted rows suggest that the BOD members were transferred from the pre-corporatized PICC.

Table 6.1b Biographical Backgrounds of China Life's Board Members (2007)

Directors Names	Positions in the Board	Other and Previous Positions
Yang Chao	Chairman of the Board	President and Secretary of the CCP Committee of the Group Company
Wan Feng	President	Vice President and Member of the CCP Committee of the Group Company
Shi Guoqing	Non-Executive Director	Vice President and Member of the CCP Committee of the Group Company
Zhuang Zuojin	Non-Executive Director	Vice President and Member of the CCP Committee of the Group Company
Long Yongtu	Independent Non-Executive Director	Former Vice Minister of the Ministry of Commerce
Sun Shuyi	Independent Non-Executive Director	Executive Vice President of China Federation of Industrial Economics
Ma Yongwei	Independent Non-Executive Director	Former General Manager of PICC and former Secretary the CCP Committee of PICC
Chau Tak Hay	Independent Non-Executive Director	Special Consultant of the Ministry of Commerce

Source: China Life 2007 Annual Report and Interviews

Table 6.1c Biographical Backgrounds of China Life's Board Members (2012)

Directors	Positions in the Board	Other and Previous Positions
Yang Mingsheng	Chairman of the Board	President and Secretary of the CCP Committee of the Group Company
Wan Feng	Executive Director	Vice President and Member of the CCP Committee of the Group Company
Lin Dairen	Executive Director	Vice President and Member of the CCP Committee of the Group Company
Liu Yingqi	Executive Director and	Vice President and Member of the CCP Committee of the Group Company
Miao Jianmin	Non-Executive Director	Vice President and Member of the CCP Committee of the Group Company, Chairman of both China Life Asset Management Company
Zhang Xiangxian	Non-Executive Director	Vice President, Member of the CCP Committee, and Secretary of Commission for Disciplinary Inspection of the Group Company
Wang Sidong	Non-Executive Director	Vice President and Member of the CCP Committee of the Group Company, Chairman of China Life Investment Holding Company
Sun Changji	Independent Non-Executive Director	Vice Chairman of Bank of China (Hong Kong)
Bruce Douglas Moore	Independent Non-Executive Director	Partner-in-charge of Asian actuarial services for Ernst & Young
Anthony Francis Neoh	Independent Non-Executive Director	Member of the International Consultation Committee of the CSRC
Tang Jianbang	Independent Non-Executive Director	Chairman of the Supervisory Committee of ABC-CA Fund Management

Source: China Life 2012 Annual Report and Interviews

Accordingly, managers consider themselves as subordinate staff appointed by the superior shareholding agency who must accordingly act in best interests of the parent company instead of minority shareholders and/or creditors (IN1, 2010; IN9, 2010; IN4, 2011). The following statements from senior managers reflect this:

- *“(The interviewer asked: When you are making major managerial decisions, do you feel that you have to be responsible for the interests of other public investors?) No, we do not have to. We just need to implement the business and managerial tasks issued by the Company’s headquarters and/or the shareholding company”* (IN14, 2010);
- *“The Chinese media often emphasizes that managers in listed companies should prioritize the interests of public investors and take their interests into consideration. However, for the managers in China, the shareholding company is the most influential investor. As our major equity provider, we should act in its interests”* (IN16, 2010).

Outside director independence was seen as impaired by ownership concentration and nomination mechanisms (IN4, 2011). According to the CSRC guidelines, independent directors should be nominated by current board members and those shareholders with more than 1 per cent of outstanding shares, and needs further approval from shareholders’ meetings. While the “leading team members” retain the veto power over independent directors’ nomination and remuneration, the Company Law and other regulations impose no restriction on corporate controllers’ power and grant no special privilege to minority shareholders. Such constituency base had an adverse impact the independence of outsider directors. Although these directors appear free from insiders’ influence, they are less “independent” than expected. One former independent director pointed out that the “leading team members” of the Group Company often wished them to be satisfied with “just raising their hands”, and “helping the Company merely comply with regulations” (IN3, 2010). In this case, their access to corporate information is also highly questionable. As they can hardly monitor the activities of these key personnel, the roles of independent directors remain large consultative and supplementary (IN4, 2011).

In addition, lack of business expertise restricts independent directors' potential oversight. Senior executives commented:

- *“When some retired enterprise cadres and officials were appointed as non-executives directors, the biographical section of annual reports often stated that they had extensive*

business experience in insurance and other industry over the past decades. During this period, they were serving as senior executives in the large state-run units, the predecessors of many restructured corporations” (IN9, 2010);

- *“With limited market competition, these large state-run units operated more as the administrative agencies than as business entities. Therefore, their senior managers had limited knowledge and/or expertise about how to manage an insurance company in an increasingly competitive environment. In this sense, the unveiled malpractices cannot wholly be attributed to the grass-root managers. Even the Company’s leading team lacked a sense of risk control” (IN5, 2010).*

The Chinese supervisory board (SB) is also limited in terms of monitoring corporate management. According to the 2005 Company Law these should play two major roles: (1) supervise the corporate management and (2) examine company financial and accounting affairs. However, informants here judged their role largely symbolic, raising questions about such SB’s own composition. Under concentrated ownership, controlling shareholders could select “insiders” to serve as supervisors “so that they would not question directors’ decisions” (IN4, 2009). Two senior executives commented on such boards' nomination and composition thus:

- *“The monitoring and decision-making power of the SB in Chinese companies is much weaker than their German counterparts. A main reason is that the Chinese supervisors are nominated and appointed by the directors, whilst a German supervisory board consists of supervisors elected by the employees... Ownership control allows the ‘leading team members’ to appoint the people they favoured insiders as supervisors, whilst other people, including investors and employees have no influence over the nomination and approval process” (IN1, 2010);*
- *“The SB usually consists of government officials, other senior managers, and cadres from the non-functional committees, such as the labour union and employee representative committee. Their administrative rankings of supervisors are usually half-class lower (than directors). Organizationally, the supervisory board is subordinate to both the board of directors and the party committee” (IN4, 2009).*

As the appointment and remuneration are determined by the directors, supervisors have virtually no independent from the corporate management. The former secretary of the board

also added:

“The (2005) Company Law does not stipulate that boards of directors and other senior executives have to report regularly to the supervisory board. In addition, since the directors and other senior executives are nominated by the parent Company and have to be approved by CIRC, supervisors, in essence, have little influence in the selection of directors and managers and by no means can discipline them. All these disincentives deter the Company’s supervisors from actively carrying out the monitoring function” (IN5, 2011).

Lack of financial and business expertise also causes the role of Chinese supervisors to be more “decorative” than functional (Lin et al., 2009). It has often been complained that the supervisors’ professional qualifications are inferior to those of the Company’s senior executives, rendering it impossible to make informed corporate decisions (IN7, 2011). As an attempt to retain the legacy of “democratic management by workers”, more than 40 per cent of the BOS positions are traditionally held by “the reallocated government officials and labour union cadres”. In fact, the published announcements by the supervisors rarely contest the decisions made by boards of directors and company executives (IN5, 2011). The passive role of supervisors can be reflected by the fact that the meetings of China Life’s SB are less frequent and less well attended than the BOD, as indicated by the minutes of board meetings. All these lead supervisors to undermonitor enterprise operation (see also Xi, 2006; Gan, 2001). While the introduction of BOD and SB may fall short of expectations by policy makers, responses to questions regarding their actual functions suggest that the transplanted institutions have been purposefully manipulated by corporate insiders:

- *“The leading members (of PICC) occupied the important positions of the BOD. Being the top executives of a listed company meant a significant increase of power and financial income. These lucrative positions should be allocated to their allies... The appointment of directors and other senior executives essentially represent the interest reallocation (among the insiders)” (IN11, 2011);*
- *“If you look at the career background of the independent directors in large SOEs, most are senior government officials and influential scholars. For these top executives, having them serve on the BOD as their colleagues can help them strengthen their ties with the other senior government officials and bolster their lobbying power” (IN13, 2010);*
- *“The independent directors and supervisors can help the executives build up their*

personal connections and advance their bureaucratic career path (shitu in Chinese)” (IN5, 2010).

Where the “guanxi-based” cultural environment is still prevalent in contemporary Chinese society, an executive can become a fast climber by his previous accumulation of intra-organizational network. Widely cultivated, and constantly reinvented, such personal connections were used to pursue the interests of particular actors (Lin, 2001). Given the resultant institutional vacuum from board inefficacy, they became the essential ingredient in the expectations and strategies between corporate executives and their political allies. It was mainly through their personal connections with the officials that many interviewed executives sought career development opportunities and/or regulatory penalty exemptions. Legacy of bureaucratic hierarchy and ownership concentration further foster a corporate culture in which executive-official collusion is accepted or even condoned. Having the bureaucratic elites seated in the boards further institutionalized such informal connections and/or collusions, thus:

- *“Some of the supervisors and (independent) directors were senior government officials with higher administrative rankings than the directors. Servings as the board members can bring them extra income while increasing their publicity in business sector”* (IN4, 2009);
- *“Outside directors have always been indispensable social resources for the listed companies. They not only help the executives get acquainted with the relevant policy concerns and business opportunities, but also expand their personal network with the national leadership... These are invaluable resources for the executives’ career advancement”* (IN1, 2010);
- *“The reallocation of some veteran cadres, in particular those who have been working since the PBOC era, constituted one of the biggest challenges for corporate restructuring. In spite of their limited business expertise, their influence and bureaucratic connection must not be overlooked”* (IN27, 2009);
- *“Newly elected BOD members often allocated senior executives and other senior party cadres into the SB in exchange of their support in corporate affairs. Serving as the supervisors, they were still considered senior executives. This was to show respect to, or to “give faces” (gei mianzi in Chinese) to the veteran cadres. (IN7, 2011);*

- *“While their administrative rankings remain the same, they received the higher remuneration than they did during the pre-restructuring era. In exchange, they would not raise appropriate objections during corporate decision-making. The formation of BOD and SB was essentially a political process. It was a process of interest redistribution”* (IN11, 2011).

These statements suggest that the institutions of independent directors and supervisors brought between incumbent corporate insiders and powerful government officials; as a result, insiders captured and expanded their personal connections while others increased their monetary rewards (see also Xi, 2006). Such collusion was closely coupled with providing material benefits to the officials concerned (see also Lin, 2001). This inevitably limited the neutrality and objectivity of BOD and SB in management oversight. Such accounts also indicate how the implementation of board institutions had been shaped by the calculation of corporate elites' self-interest, further linked with the mutual benefits cultivated by favour seekers (see also Lin, 2001). In this regard, the formation of boards could be conceived as a complex process in which agents were organized in coalitions and even sub-coalitions (Huse, 2007). The coalition patterns and/or strategies have distinctive preferences and objectives, which make negotiation and bargaining among corporate insiders common practices (Huse, 2007). Goal conflicts, including the personnel reallocation and profit remittance, were solved through political bargaining in the guise of 'introducing modern enterprise institutions'. The board institutions became a network of bureaucratic and corporate elites of which the primary purpose was to retain power to protect their own interests (Saich, 2011, p. 140). Such competing informal institutions subverted or even diminished the efficacy of formal enterprise institutions, which in turn shaped the organizational design, goal-setting, and problem-solving processes in China Life (Estrin and Prevezer, 2011).

6.4.3 Overseas Listing, Transparency and Further Reform Drive

In July 2003, China Life selected China International Capital Corporation, Citigroup, Credit Suisse, and Deutsche Bank as the chief underwriters, Lehman Brother as the financial advisor, and PwC as the external auditor. China Life's roadshow in Hong Kong witnessed particular interest and participation from foreign investors. On 17th and 18th December 2003, the company launched IPOs on both the Hong Kong Stock Exchange (HKSE) and the New York Stock Exchange (NYSE) to attract as wide a pool of investors as possible. The IPO

proved a huge success, raising US\$ 3.48 billion and becoming the world's largest IPO for that year. The number of issued shares totalled 7.441 billion, of which 6.765 billion were newly issued and 900 million were the liquidated shares by the Group Company.

Although the overseas listing of China Life has been effective in terms of capital raising, there has been some debate about whether cross-border listing leads to a meaningful improvement in the Company's governance practices. This is because IPO success could be partly due to the high asset quality and business prosperity in the mainland insurance market. On February 2 2004, publication of the 2003 Annual Audit Report by the National Audit Office (NAO) revealed that the pre-restructured company had business and financial irregularities involving RMB 5.4 billion (US\$ 652 million) (Chan, 2012). These included RMB 2.5 billion (US\$ 302 million) in unauthorized investments and loans, RMB 2.38 (US\$ 287) billion in illegal agent services and the overpayment of insurance policies, as well as RMB 31.79 million (US\$ 3.83 million) in hidden cash reserves (*xiaojinku* in Chinese). In a statement on the NAO's website, Li Jinhua, head of the NAO, claimed that, up to 2002, China Life's state-owned predecessor had made investment decisions not permitted by the Chinese Insurance Law, and employed unqualified insurance agents. In addition, several branch companies of China Life were found to have misreported their expenses and income for tax underpayment. On the same announcement date, China Life made its own statement, stressing that these financial irregularities only occurred in the pre-restructured company and had no connection with the newly listed company.

On 16th March 2004, a class-action lawsuit by Roy Van Broekhuizen was filed in the United States District Court for the Southern District of New York on behalf of purchasers of China Life's publicly traded securities covering the period between December 22, 2003 and February 3, 2004. Another eight class-action lawsuits had been filed over the first half of 2006. According to the consolidated amended complaint filed on January 19 2005, the company, together with some of its former directors, including Wang Xianzhang (former president), Long Yongtu (former independent director), Chau Takhay (former independent director), Miao Fuchun (former executive director), and Wu Yan (former executive director), were charged with the violations of Sections 10(b) and 20(a) of the Securities Exchange Act of 1934, and Rule 10b-5 promulgated thereunder. It was alleged that these defendants failed to disclose and indicate that China Life and its predecessor company had engaged in a huge financial fraud, including illegal and unauthorized loans, investments and payments.

Meanwhile both the US Securities and Exchange Commission (USSEC) and Hong Kong Securities and Futures Commission (HKSE) launched informal inquiries into the issue. David Webb, independent director of HKSE urged immediate suspension of China Life's share trading unless related accounting problems were properly resolved. China Life thus became the first Chinese SOE to encounter the disciplinary force of international financial markets. Risk of expropriation and other governance malpractices, including governmental influence concerned both public investors as well as regulatory bodies. The revealed financial irregularities also raised further concerns about state-led restructuring, as expressed thus:

“The restructuring was largely completed through administrative means. Investors were simply unfamiliar with such a non-market-based method. The revealed problem severely impaired the image of Chinese SOEs already listed overseas and those about to be listed” (IN5, 2012).

The Company's defendant lawyer from Sidley & Austin LLP added:

“What the investors were concerned with was the complexity of the spinning-off process. They believed that ownership dominance would allow the Group Company to extract the profit (from the listed company) in order to cover the spread loss” (IN30, 2010).

Company financial statements did not disclose the full detailed process of corporate restructuring, so public investors could not discern their exposure to financial risk. Managers of Hutchison Whampoa – one of the earliest strategic investors in China Life – expressed their further concerns thus:

- *“Top executives in the Group Company consisted mainly of former officials from different government agencies. They were unfamiliar with the operation of the insurance business. Their bureaucratic mind-set was the major obstacle to communication with other institutional investors”* (IN32, 2011);
- *“Most of these senior executives carried a dual-identity as both as corporate manager and as state cadre. Many (investors) were worried that the listed company would be used as an instrument for implementing policy goals. When superior officials issued orders or set guidelines, you can hardly guarantee that they would reject them”* (IN33, 2011);

- *“We worried that the government might use its control to allow tunnelling of the profits in order to accelerate the settlement of the spread loss problem. If it was determined to do so, the listed company could hardly say no” (IN34, 2011).*

These concerns suggested that the spin-off scheme, as an innovative policy option, was pressured from public investors and regulatory bodies (IN25, 2009). Over the following weeks, China Life’s N- and H-share prices plummeted by approximate 30 per cent – 29.8 per cent for H-shares and 32.2 per cent for N-shares – from their respective post-IPO highs. The unexpected capital loss and potential regulatory sanctions and payment of legal fines caused particular concerns:

- *“Losing the lawsuit would not only incur significant financial losses to the company, but also hinder the process of restructuring the financial sector. This damages the image of Chinese SOEs. In this sense, this issue is also of great political concern” (IN28, 2011);*
- *“This (the share price decline) represented a depreciation of state owned assets. If we lost the case, the newly listed company would carry a huge financial burden onwards. This would hinder its business expansion in both domestic and overseas markets” (IN29, 2011).*

China Life was forced to improve information disclosure. To cooperate with the SEC’s informal inquiry, it had provided the required documents and other materials related to the settlement of spun-off assets. These included official agreements regarding the investment return distribution between the MOF and Group Company. While such information was once classified as “business and political secrets”, officials and executives now felt obligated to disclose such “soft information” in an attempt to restore investors’ confidence and trust. A former independent director of China Life pointed out that the complexity of Chinese SOEs’ restructuring has needed to be more transparent thus:

“China Life’s Level-3 ADRs already represent the highest level of regulatory requirements for non-U.S. listed companies. This means that China Life is required to adhere to the equally stringent rules followed by U.S. companies. We did not expect that the foreign investors’ requirement on information disclosure would be so strict and attentive. This required significantly higher standards of information disclosure” (IN3, 2010).

The former secretary of the Board had a similar perspective:

“Providing adequate information disclosure, especially the resolution arrangement between China Life and MOF, was a prerequisite for easing doubts and restoring confidence. Due to the complexity of the restructuring program, we need to supply enough information to reassure public investors. The resultant higher levels of corporate transparency will certainly help repair China Life’s image” (IN5, 2012).

On June 2, 2006, the enforcement division of USSEC announced that its almost 2-year long investigation had ended without future actions being recommended. On 3 September 2008, the New York Southern District Court found that the plaintiffs’ claims lacked merit and therefore dismissed the complaint (Oliver, 2008). Thus class-action lawsuits against China Life concluded. In response to USSEC’s decision to end its probe, the chief representative of the Beijing office of Sidley Austin LLP at that time commented:

“As far as the stock listing procedures are concerned China Life’s IPO in 2003 was in full compliance with the requirements of the regulators of the stock exchanges where the Company is listed. We believed that USSEC’s final decision is due to China Life’s active co-operation during the investigation. Through our communications with USSEC staff, we learned that they are very appreciative of and satisfied with the assistance and co-operation from China Life” (IN30, 2010).

However, as a former non-executive director in the BOD noted, concerns about financial risk control and potential expropriation by the controlling shareholder have never been dismissed. The case put the corporate governance of overseas-listed SOEs under the international spotlight for the first time. Although China Life was exempted from certain legal liabilities and potential fines, the higher standard of corporate governance imposed by advanced capital markets challenges both China Life and the Chinese government. As a former Board secretary put it: “despite little influence in the BOD, public investors may choose to vote with their feet and cause a dramatic share price decline. This raises both financial and political concerns for the government” (IN5, 2011).

Financial economists often contend that the state sector makes the party-state better equipped to bear the risk than the normal investors do as a class, thus leading to its passive role in curbing malpractices. However, the narrative accounts here suggest that the (negative) signalling effect and political significance of any corporate scandal was simply non-diversifiable. The regulatory arbitrage and disciplinary power of capital markets make

the state-owned insurer opt for higher levels of information that put the spotlight firmly on governance practices. One prominent example was the immediate suspension of previous welfare benefits following overseas listing. Amid intensifying market competition, incumbent managers found it increasingly difficult to promote their own interests by improving the profitability to which their salaries and bonuses were tied (IN3, 2010; IN5, 2011). They could still accommodate such disciplinary power by appropriating enterprise assets for welfare expansion and counting personal spending as sales cost (see also Lin, 2001). Nevertheless, overseas listing and higher disclosure standards increased the exposure of executives and officials to legal liability for financial irregularities and other malpractices. In light of this, housing has no longer been provided as an occupational benefit since 2004 (IN1, 2009; IN3, 2010; IN5, 2011). Other “non-salary welfare” (*feigongzi fuli* in Chinese), including shopping cards with prepaid deposits and car provision for retired managers, were also curtailed. Executives observed that “the abolition of these welfare benefits not only alleviated the Company’s financial burden, but also reduced the possibilities of hidden malpractices”, as “many welfare provisions were drawn from the hidden cash reserves held in different branch companies”. (IN15, 2011; IN17, 2011). As indicated by Table 6.2, international listing and the improved governance practices significantly improved the Company’s profitability and operational efficiency over the following years.

Table 6.2 Profitability and Efficiency Comparison

	Operating Profit Margin (%)			Return on Assets (%)		
	China Life	Ping An	China Pacific	China Life	Ping An	China Pacific
2008	15.41	18.18	10.52	2.28	0.04	0.6
2007	24.85	16.38	11.08	4.69	3.18	2.96
2006	15.99	10.38	18.45	3.13	1.95	0.77
2005	11.96	8.25	6.18	2.84	1.46	0.81
2004	10.36	1.65	-11.23	2.74	1.33	NA

Source: DataStream

Summing up, China Life introduced modern governance institutions in light of the looming capital shortage and regulatory pressure. Where the ownership remained highly concentrated, such formal compliance alone did not translate into essential improvements in the Company’s governance practices. In spite of the huge success in capital raising, the lack of essential constituencies – including qualified executives and supervisors – and complementary institutions mediated the board’s monitoring duties and thus hampered its

ability to fulfil strategic functions. Skilled executives purposefully and systematically exploited the lax governance structures and institutional vacuum to expand their political interests and wealth. In short, transplanted board institutions failed to discharge their full governance responsibilities. Nevertheless, changes in capital structure and regulatory environment provoked the open clashes between the market-oriented governance mechanisms and the administrative-driven approach of corporate restructuring, as indicated by the class-action lawsuits. The improved information disclosure and abolition of traditional welfare benefits suggest that the newly empowered stakeholders brought in not only the normative credibility pressure, but also the cognitive reorientation among the corporate executives and officials. Where these changes in the periphery did not pose a direct threat in the eyes of the vested interests, they continued to have profound effects on China Life's governance system and practices.

6.5 Power Tension, Party Control and Internal Audit (2004 up to now)

In addition to investor concerns, the partial stock flotation and translation of western CG system have been problematic, while most market-based SSG instruments are still emerging (OECD, 2005b). The legacy of ownership control, combined with more decentralized state administration, has enabled the semi-bureaucratic Group Company to dominate major decision-making. Such enlarged economic and politic influence has increased the leverage of *the intermediate principal*, and thus resulted in power tensions with the listed company and the state (see Lin and Milhaupt, 2013). One distinctive feature of reform since 2004 has been the reconsolidation of state ownership rights, particularly regarding managerial monitoring and performance evaluation.

6.5.1 Rising Power Tension

As stipulated by the agreement between the MOF and CIRC, dividends remitted by the listed entity constitute a major part of capital inflow to resolve spread loss. In 2012, the dividend remitted to the Group Company totalled RMB 2.7 billion (USD 441 million). Such financial reliance formally suggests that “major decisions (of the Group Company) have traditionally been made in accordance to the business interests of the listed company” (IN5, 2012). Over the period 2003-2012, the asset base and premium income of China Life have increased 578 and 509 folds. Meanwhile, the share issuance in 2007 alone enabled the shareholding agency to raise more than US\$ 3.8 capital. Where ownership control allows the Group Company to capture the largest benefit of the growing business, the parent company was no longer the

“dying dinosaur” draining the state’s fiscal subsidies (Rolston et al., 2006). As noted, years of remitted share dividends and stock market booms have significantly improved the financial soundness and asset quality of the parent company, which in turn may “mitigate investors’ worries regarding expropriation” (IN5, 2012). For the “leading team members” once besieged with the financial fragility, the unprecedented business prosperity simply brought in the invaluable chances to enlarge their political influence (IN28, 2011; IN29, 2011). The ownership control enabled these already politically well-connected executives to channel the necessary resources for fulfilling their ambitious business expansion.

On 4th March 2009, the Group Company was rumoured to have bought out AIA’s Asian Pacific business division as part of its overseas expansion plan (Financial Times, 2009). This came not long after Pin An’s huge loss incurred from its investment in Belgium insurer Fortis, and thus triggered controversy regarding the reckless expansion of Chinese financial institutions (Rabinovitch and Fontanella-Khan, 2012).⁸ For the regulator, the acquisition proposal was rather “immature” and “unprepared”. In addition to the overwhelming spread loss, the Company still needed to overcome a myriad of challenges, including the lack of technocratic and managerial competence, as well as financing and regulatory barriers (IN1, 2010; IN28, 2011; IN29, 2011). On the other hand, the unprecedented overseas expansion would inevitable escalate the managerial burden that was already struggling under the fierce domestic competition (IN15, 2011; IN21, 2011; IN14, 2010). It is noteworthy that since 2006, there has been a growing tendency to promote top SOE executives to provincial governors and central ministers. In the eyes of many managers, the “leading team members” were simply pinning their hope on the expanded asset base as the springboard towards national leadership (IN20, 2010; IN23, 2011). The following divergent views regarding overseas expansion among regulatory officials and corporate executives reflect such tension:

- *“AIA has always been a model for China Life since the 1990s... The financial crisis provided the company with a unique chance to acquire the premium assets at a lower price. However, the current management and administrative expertise was simply incompatible with its expansionary pace”* (IN28, 2011);
- *“The Company has been actively expanding its investment channels in order to resolve the spread loss. But the current regulatory framework takes a rather prudent and restrictive attitude towards insurers’ overseas investment. The evaluation and approval*

⁸ The investment loss was estimated US\$ 3 billion by September 2012.

process tend to longer and stricter. This is particular so following the significant investment loss of China Aviation Oil and Ping An” (IN29, 2011);

- *“This acquisition would have caused great pressure upon the listed company. In addition to the efficacy of risk control, the personnel training system and managerial expertise required significant improvement to match international standards. They (decision-makers in the Group Company) obviously have not taken into account the Company’s ‘soft skills’” (IN14, 2010);*
- *“Apart from the managerial burden, the significant cash outflow would impair the Company’s solvency capacities towards international customers. The limited reserve of foreign currencies was large contributed by the overseas share sales” (IN1, 2010).*

The sales and marketing manager of a Beijing municipal city branch provided this cautionary tale:

“In 2009, a delegation consisting of the general manager and other sales and marketing staff arrived in Moscow seeking to expand the cooperation with local insurer on tourist medical services. One week preceding the delegation’s arrival, the Group Company announced its acquisition proposal of a major Russian iron miner. This news aroused much controversy among the Russian media regarding the Chinese SOEs’ ‘neo-colonialist’ expansion. Such sentiment inevitably impaired the reputation of the listed company and hindered the negotiation process” (IN17, 2011).

Examples of this sort were abundant. Large Chinese SCCs now attract more such criticism regarding their economic privileges and investment spending. Where such activities are found to contradict public interest, it is said to have ‘hijacked’ the stated reform policies (Wu, 2005; Dyer and McGregor, 2008). All these reveal “the emergence of major corporate entities as strong political players” in China’s economic life (Saich, 2011, p. 288). The trend has drawn not only upon the government-sponsored programme of “fostering national champions” but also rising independent initiative amidst continued economic growth.

While such misuse was cited as an indication of their expanded economic and administrative privileges, rising executive compensation attracted other criticism as well. Wage reform has been a key component of China Life’s governance reform. Under the transition process, the past seniority-based system was rejected, and a firm and/or branch-determined, individually differentiated and merit-based system employed instead. One noticeable change was how

incentives became progressively more open-ended, with a fixed base being supplemented by a “floating element” linked to premium growth. With increased power over wage determination, executive salaries indeed increased threefold over the early 2000s (IN21, 2010; IN19, 2011). In political terms, excessive managerial compensation – like unregulated managerial buyouts – pointed criticism towards the CCP elites in particular. In economic terms, if executives could determine their own compensation, they may lack incentive to improve business performance in response to other shareholder demands. In December 2006, China Life introduced an option scheme as an attempt at “linking executives’ remuneration with firm performance” (IN1, 2009). Various stock options were granted to senior executives according to their administrative rank. With the predetermined exercise price of HK\$ 6.86, holders may exercise their options on a number of pre-specified dates (IN5, 2011). The introduction of equity-based incentives occurred just when China Life’s H-share price rose on the country’s booming economic growth. Many observers believed this could signal convergence of remuneration practices towards international standards. In the regulator’s view, the option scheme might fail to mimic the same function found elsewhere however. It was largely based on executives’ opportunism amidst bullish market sentiment (IN28, 2010). In particular, the absence of an effective regulatory framework increases the probability of opportunistic timing, and creates an incentive to manipulate share price through accounting accruals (IN29, 2010). Executives driven by speculative (financial) gains can only have short-term self-interest at heart, and lack wider loyalty to shareholders and employees (IN29, 2011). For MacGregor (2010, p. 103), the options are essentially the “calculated ruse” to ensure that entrenched insiders can capture the biggest financial gains possible from selling shares offshore. CIRC feared that the unchecked increases in managerial compensation would exacerbate already growing national discontent over widening income disparity. In October 2007, CIRC formally suspended China Life’s options scheme. This showed central policy makers’ caution over experimenting with market-oriented governance mechanisms in large SCCs – a political sensitive issue in which various forms of rent-seeking can occur under the guise of “establishing modern enterprise institutions”.

6.5.2 Renewed Political Control and Management Oversight

Since the mid-2000s, the party-state has repeatedly asserted that further reform initiatives will alleviate insider entrenchment (see Naughton, 2006, 2008). For central policymakers, reforms, in particular the empowerment of the State Asset Supervision and Management

Commission (SASAC), challenge shareholding agencies' ability to extract the traditional private benefits of control, and perhaps to a lesser extent, senior executives' ability to serve personal interests (Xi, 2006). The fundamental idea underpinning these is to safeguard, as well as exercise, state ownership rights in a centrally unified manner while complying with relevant laws and regulations (IN9, 2010; IN10, 2010). They represent an important step towards reinforcing the role of the state as an owner and shareholder of the state sector (OECD, 2005b). For China Life, three policy priorities appear key for achieving this aim: 1) maintaining and strengthening political oversight; 2) improving recruitment procedures for corporate executives as well as performance evaluation; and 3) restricting irregular conduct through professional regulatory bodies.

Where the party-state maintains control over large SOEs, it chooses to do this not by direct intervention, but by strengthening its control over personnel selection and dismissal. While privatization and ownership diversification were restricted to "small and medium-sized enterprises with severe deficits", they were often popularly termed the 'dross' of the state sector beyond salvation (McGregor, 2010, p. 39). In a speech to China Life's top executives, Yuan Li, the former assistant President of CIRC stressed:

"The relationship between the Group and listed companies is a 'mother-and-son' relationship; the relationship between the two commissions in CIRC and China Life is a 'superior-and-subordinate' relationship" (IN1, 2011).

In the Investment Department of the Group Company, a Director serving as member of the party commission added:

"China Life will represent more than RMB 1,000 billion assets (by the end of 2010). Its importance in sheer fiscal income, financial market development and employment means that the state will not easily relinquish its control over such an important company" (IN1, 2011).

The following quotes typify the party's persistent influence over the corporate agenda.⁹ They elaborate upon decision-making within related party cells thus:

- *"Party committees in regional branches and headquarters are under the direct control*

⁹ As noted by some senior executives, "when you are talking about the decision-making process in an SOE, it is essential to bear in mind the 'second identity' of the corporate executives: they are not merely business managers; more importantly they are party cadres" (IN4, 2009).

and supervision of the superior committees of the Group Company and CIRC. Both are under the direct supervision of the Central Organization Department of the CCP” (IN27, 2011);

- *“As stated, the party manages the cadres, most of the middle and senior managerial positions are held by the members of the party committees at various levels. For example, in a municipal branch, the branch director is often the secretary of the corresponding party committee. Members of the leading team of this branch must serve as the members of this party committee” (IN28, 2010);¹⁰*
- *“While daily business decisions are discussed and decided within business meetings with other managers, decision regarding the appointment or dismissal of managerial personnel must be submitted and approved by the party committee beforehand” (IN4, 2009);*
- *“Since most of the middle and senior executives are members of the party committees, major and important business proposals submitted to various departments including the BOD and the BOS are actually decisions that have already been ‘filtered’ and approved by the party members” (IN16, 2010).*

For McGregor (2010, p. 69), “the party’s control over personnel was at the heart of its ability to overhaul state companies, without losing leverage over them at the same time”. In actuality, numerous policy decisions, ranging from restructuring of the financial sector in the late 1990s up to regulatory reform of the security market were accomplished with the political authority exercised through centre Party leadership’s power over grass-roots units (McGregor, 2012). However, decades of economic liberalization and rapid growth have undermined Maoism and central planning. From the “New Generation with Four Qualifications” by Deng Xiaoping to the “Three Representativeness” of Jiang Zemin, Party leadership pursues ideological shifts for maintaining political legitimacy (Holbig, 2006) reflecting a delicate balance between continuity and change.¹¹ At enterprise level,

¹⁰ As a retired senior executive of the Group Company exemplified, “for example, the administrative ranking of the Company’s president is equivalent of a vice-minister in the central government, while the heads of the Company’s provincial branches are ranked the same as the mayors of municipal cities. In the past, redeployment across different systems occurred regularly. Leaving their administrative posts, some former local officials had often been reappointed as the managers or deputy managers of the branch companies, while their new rankings were dependent on their previous administrative posts” (IN6, 2010).

¹¹ Wu (2005, p. 170) remarked that “this common practices of the corporate system is incompatible with China’s current system of the party’s organization department and the government’s personnel department appointing the officers of enterprise.” However, underneath the “staticness” of the control hierarchy is a

competition has brought further ideological reconstruction among party cadres, shifting from once highly decorated political loyalty towards more exclusively economic priorities. One prominent example of this shift concerned the different evaluation criteria for enterprise cadres, as illustrated by former members of the CCP Central Financial Work Commission thus:

- *“Our commission was founded in 1998 when most regulatory bodies (in the financial sector) were still absent. Thus the commission was empowered to supervise the country’s financial system on behalf of the CCP’s central leadership” (IN27, 2010);*
- *“There were two major criteria for personnel evaluation. One was political performance and discipline; the other was business expertise and leadership capability. While the first criteria were often referred to as ideological loyalty to Maoism and Socialism in the past, it has been reinterpreted as managers’ compliance with relevant laws and regulations. For example, we would cooperate with the state’s audit department and other judicial bodies to investigate whether the nominated executive has been connected with any illegal practices or other business misconduct through their career. Once any of these deviations was found out, the nomination would definitely be rejected”(IN26, 2010);*

Two senior executives explained business expertise and leadership thus:

- *“Business expertise is mainly judged by whether the manager can fulfil the business target assigned the superior department. Apart from the sales quotas, the soundness of insurance product structure, the control of administrative cost, and financial management are all included” (IN15, 2011);*
- *“At the same, the party committee will also consider the candidate’s professional qualifications and experience. Nowadays, most middle and senior managers in China Life have the bachelor-level education or even above. This contrasts significantly to the pre-restructuring era when the majority of the staff only finished their secondary schools and colleges” (IN8, 2012);*
- *“In fact, business expertise and leadership become the more important criteria for managers’ promotion and appointment compared with the past. Although political studies*

significant transformation in both ideological and practical fronts. On the one hand, the criteria for personnel evaluation and appointment show a high degree of adaptability in the light of the changing social-economic reality.

remain indispensable for party cadres, and conventional socialism ideologies are still often emphasized on important political occasions, for us, the only way to put the latest socialism principles into practice is to improve the profitability of the company and maximize the returns to the shareholders, in particular our controlling shareholder” (IN5, 2012).

For McGregor (2010, p. 67), the notion that the maximization of shareholders’ interests is connected to the socialists’ ideology is “novel”, whether for advanced capitalist countries or China, but competitive pressure from marketization also offers new opportunities for revitalizing CCP’s political control. It will no longer be necessary to rely upon socialism and/or Maoism but as the ruling party it can operate on the basis of national interest and stress the indigenous nature of the “Chinese revolution” (Saich, 2011, p. 93).

However, the comprehensiveness of the *nomenklatura* system and the innovativeness of ideological reconstruction do not directly translate into consolidated control over the state sector. Unlike other industrial sectors, banking and insurance do not come under the oversight of SASAC, leaving a gap in the central leadership’s supervision of lenders and insurers. For some time this vacancy was filled by a vice-ministerial-level regulator, i.e. CIRC. While CIRC’s ability to improve corporate governance practices remained in question, central leadership was concerned that the “close-knitness” (or *bangpai guanxi* in Chinese) of this regulatory connection may further entrench insiders’ interests (IN5, 2011; IN21, 2011). On May 22 2012, the leadership of China Life significantly changed. Apart from the reassignment of two non-executive directors, the central party leadership once appointed Yang Mingsheng, former president of Agricultural Bank of China as its new chairman, replacing his predecessor (i.e. Yuan Li) merely two months after the former regulatory official first came to office. One senior official in CIRC here commented:

“The meaning of this personnel change is two-fold. It is generally acknowledged that Yuan’s appointment as the China Life’s Chairman was largely due to his close personal connection with the CIRC’s former president, Wu Dingfu. As the longest tenured president of CIRC, the interest and influence of Wu’s faction has been deeply entrenched within the insurance sector. This reallocation can alleviate the problem of interest groups. As the Chinese proverb says, ‘every new sovereign brings his own courtiers’ (yichao tianzi yichao chen in Chinese), the reallocation of Yuan was expected. On the other hand, China Life’s profit decline further enhanced the state’s determination to improve the competitiveness of the

state-owned insurers. Yang's comprehensive experience in the large-sized financial institutes, including the banking and insurance sectors is considered to be highly beneficial for China Life" (IN29, 2012).

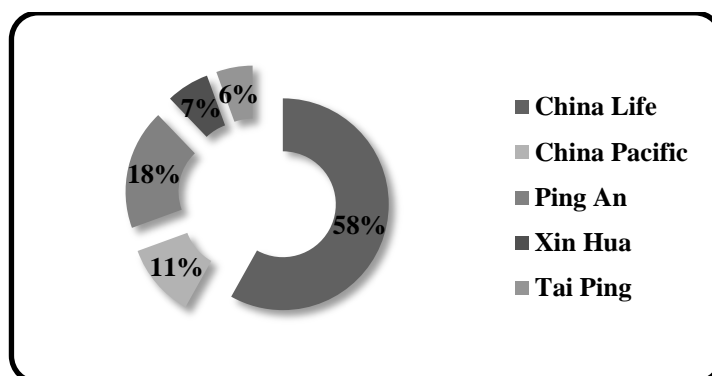
Some senior executives in China Life echoed this thus:

- *"Yuan's experience is reflected more by his work experience as a regulatory official rather than as a corporate executive. Most of the time, he appeared more as a government official than business leader. In contrast, Yang has sufficient work experience as the high-level corporate executive of a state owned financial institute" (IN5, 2012);*
- *"As the former director of the Agricultural Bank of China, Yang has extensive experience in resolving the non-performing loans and leading a large-sized financial institute. His business expertise helped him outcompete other candidates for this position" (IN1, 2012);*
- *"The central policy makers hope that he can use his experience and expertise to help China Life address the mounting problems of market share declining (as indicated by Figures 6.4a-6.4c) and (insurance product restructuring" (IN8, 2012).*

Rather than solely rely upon political means, policymakers have sought to institutionalize better oversight over corporate management. The party-state's new stance of cadre management and the empowerment of the NAO would make them the adversary of entrenched insiders and their political allies. In April 2010, several working groups from the NAO were deployed to China Life and its Group Company to carry out routine state auditing. A senior official from a working group here commented:

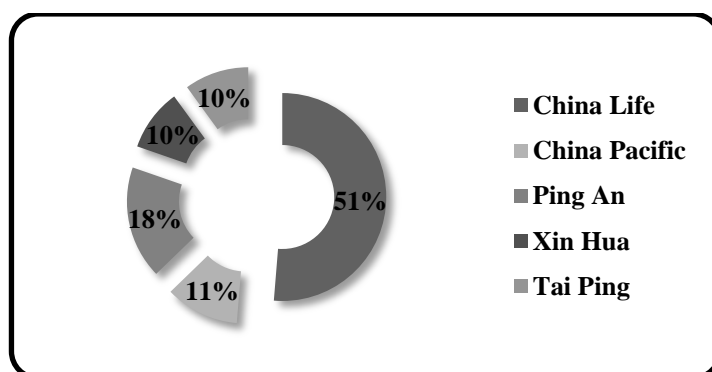
"We have the right and responsibilities to implement a thorough investigation into company's business performance and financial soundness. Our work will focus not only on verifying the financial accounts of its provincial branches, but also detecting the potential business risk and financial irregularities" (IN35, 2010).

Figure 6.4a Market Shares among the Major Life Insurers in 2005



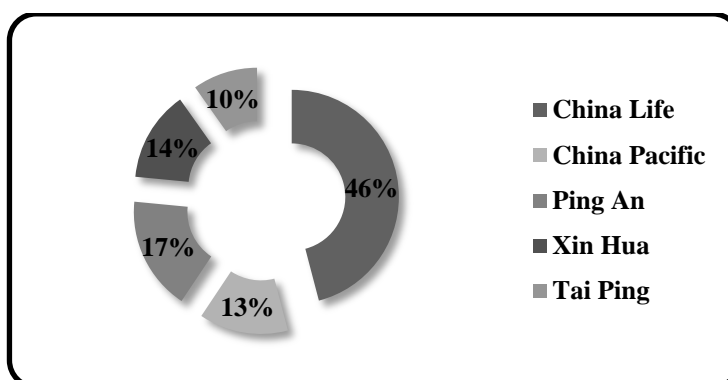
Source: China Insurance Regulatory Commission

Figure 6.4b Market Shares among the Major Life Insurers in 2008



Source: China Insurance Regulatory Commission

Figure 6.4c Market Shares among the Major Life Insurers in 2011



Source: China Insurance Regulatory Commission

A senior official of CIRC added:

“The consolidated financial statements provided by external auditors often omit some important information concealed at grass roots level. In this case, we cooperate with the working groups to carry out a thorough investigation whether the business activities are in compliance with the accounting standards and relevant regulations” (IN29, 2012).

A sales manager of the Company's Beijing municipal city branch recalled the time when a working group arrived in the Beijing municipal city branch:

“They (the auditing personnel) were empowered to scrutinize all the business accounts and financial procedures, and even freeze the capital accounts of the audited department that allegedly violate official regulations, if they deem it necessary. From top executives to sales representatives at grassroot levels, managers across the branch were instructed to co-operate with the working group” (IN18, 2010).

Managers of a provincial branch accompanying the working group thorough the entire investigation period further commented:

- *“Nowadays the NAO has obtained a much broader range of power and responsibilities than in the past. As the government agency directly affiliated to the State Council, its administrative status allows it to carry out inference-free investigation”* (IN8, 2012);
- *“Our grassroots business units have to provide the working groups and our internal audit staff with unrestricted access to the bank accounts and record of business transactions. In this case, business irregularities and managerial misconduct can hardly be concealed”*(IN14, 2010);
- *“Inspection working groups, consisting of accounting and industrial professionals, are deployed to large state owned corporations regularly at a 5-year interval. The authenticity of business revenues and cost is the main theme of the auditing programme. For insurance companies, business irregularities prohibited by CIRC, such as insurance policies with excessive premium rates, will be its other focus”* (IN11, 2011).

The growth of state audit capacity has been associated with significant cognitive reorientation. This implies that the state audit goes beyond “simply examining the regularity of financial transactions” and “engages such criteria as effectiveness, efficiency and performance as its evaluation standards” (Gong, 2009, p. 37). Indeed, a senior executive from the Group Company here added:

“In addition to the verification of financial accounts, scrutinizing the operational efficiency and business profitability of the audited companies is also at the top of the (inspection) group's priority list. The assessment criteria include the growth of premium income, the appropriateness of (insurance) product mix, as well as cost control. After all, SOEs are state

owned assets. It is the state's biggest concern whether the managers are properly held in check and the company is being managed and operated in the best interests of the equity provider. This differs significantly from the past when audit activities were used for ensuring the implementation of directive plans" (IN2, 2011).

Although the managers are still not the de facto owners of state assets, improved internal monitoring thus realigns business and managers' interests. A former deputy general manager in Beijing municipal city branch observed that audit results have therefore become closely linked to managerial promotion or dismissal:

"As the evaluation results indicate an executive's business leadership during his (or her) tenure, auditing activities are now more conducted in conjunction with promotions, dismissals, reappointments, and retirements among many SOEs' top executives"(IN16, 2011).

A senior party committee member from a provincial branch, responsible for internal discipline and control, also pointed out that the frauds and irregularities uncovered would hold restrict managerial promotion and even force senior executives to leave. He commented, in reference to the recent removal of Sinosteel's Chairman, Huang Tianwen, due to a series of financial malfeasances and investment losses, that:

"The disclosure of financial irregularities and business misconduct suggests that the convicted executives' business leadership is problematic and that they are no longer capable of leading and managing the business unit" (IN13, 2010).

The deputy director of a regional audit centre here contended that:

"On the one hand, it is important for the board to comprehend the magnitude of financial irregularities and other business misconduct in provincial branches. On the other hand, by imposing disciplinary actions or administrative punishments to convicted managerial personnel, the Company hopes that business risk can be reduced as low as reasonably practicable" (IN20, 2010).

The use of existing apparatus to regulate CG reinforces the already strong hand of the central government in the politics of corporate control (see also Culpepper, 2010, 2012). For Power (1997) the causes of enhanced state audit capacity are multiple, including not only the imposition of harder fiscal constraints on enterprises and curb abusive business practices, but

also public demand for more accountability and declining public trust in government at large. Although there is little intention to turn the NAO into an independent audit agency to oversee the central authority itself, especially leading cadres, state audit has still been institutionalized as an additional instrument to ensure that state owned corporations' business conform to central authority intentions (see Gong, 2009).

While China Life received no regulatory warnings or penalties, the following story regarding the malpractices unveiled in another state-owned insurer reflected the enhanced regulatory capacities of the NAO. By end January 2011 when most interviews were completed, the NAO charged PICC with offences including the illegal sale of policies, overstating policy sales, improper claim settlements, illegal distributions of commissions, and managers' off-the-books gains (grey income or *huise shouru* in Chinese). PICC was found to engage in about RMB 1.95 billion worth of illegal activities in 2009 (South China Morning Post, 2001). In 2012, according to the NO.109 Notice issued by the NAO, managers from PICC's Guangdong provincial branch were found to have falsified insurance cancellations and extracted premium funds worth more than RMB 29 million by means of forging the seal of the China Grain Reserves Management Corporation, fabricating cancellation approval data and deleting or reducing insurance liability terms. Accordingly, the General Manager of the provincial branch, Yu Zheng, was expelled from his managerial position and the party committee of Guangdong branch (Ren, 2012).

6.5.3 Internal Audit and Risk Control

Along with the rapid development of mainland insurance markets, Chinese regulators appreciate the growing risk factors associated with rapid expansion of insurance products and investment channels (IN21, 2010; IN22, 2010, 2011). To improve the performance of state-owned insurer, "an effective risk control system and organisational rearrangements are must be undertaken and solvency requirement must be raised" (IN22, 2010). Policy makers have become increasingly aware that regulatory shortfalls here can lead to a systemic risk in the same way that large private financial institutions have done in Europe and the US (IN21, 2010; IN23, 2011).

Between 2006 and 2007, CIRC issued the "Opinions of China Insurance Regulatory Commission on Intensifying Insurance Fund Risk Management" (2006) and the Risk Management Circular (2007). Both documents not only specify the principles of a sound risk management framework, but also identify the risk categories to be assessed and discuss the

composition of effective risk controls (KPMG, 2009). On April 9 2007, CIRC released the “Guidelines for Insurance Companies Internal Audit”, providing detailed stipulations regarding the establishment and responsibilities of the internal audit departments, staff professional qualifications, and the relationship between these departments and regulators (SinaFinance, 2007). In May 2008, China Life’s regional audit centres were duly founded. Its once-fragmented internal audit function was centralized for the first time under the direct management of the audit committee of its BOD. Two senior internal auditors illustrated the changing mission of China Life’s internal audit system thus:

- *“Prior to the corporate restructuring, the main role of internal audit was to provide the relevant financial and accounting information to the government to formulate and enforce the economic plans and control economic activities. These units were required to cooperate with the annual financial examination led by MOF. More work focus had been placed on the compliance of enterprise operations with economic policies, financial regulations, and the profit (or tax) submission schemes” (IN23, 2011);*
- *“As a result of corporate restructuring, remuneration for corporate managers started to be linked with the business performance. Many managers inflated the premium income to their own benefit and provided false financial information to conceal embezzlement and other business irregularities. Thus we had to check whether the insurance business transactions were conducted in accordance with the relevant regulations and whether there were hidden business profits that were supposedly remitted” (IN21, 2010).*

Changes in the social-economic environment impacted upon China Life’s internal audit system. However, for some time, this had adopted the director responsibility system within where internal auditors came under the direct supervision of a provincial or municipal director. A former secretary of the BOD pointed out how independence was thereby impaired:

“Inevitably, the independence of internal audit activities had largely been compromised, since audit findings often contained some unfavourable information to these directors” (IN5, 2012).

A senior audit staff-member of North-Eastern China Regional Audit Centre added that:

“Facing the risk of being demoted and even dismissed, the (internal) auditors were seeking to avoid any conflict of interest with their superiors and chose to keep silent, since they

would be the responsibility holders for the uncovered frauds... As the Chinese proverb says, 'the mountains are high, and the emperor is far away'. The phenomenon of frauds and irregularities is especially severe in county-level branches" (IN19, 2010).

As the auditors' own career prospects and interpersonal connections were not damaged, it was clear that frauds and irregularities had been omitted deliberately. This highlights the importance of due independence and objectivity in internal audit. To overcome these problems, the audit committee has reconsolidated internal audit within individual provincial branches. Meanwhile a nationwide internal audit system has also been established. Parallel to the provincial business branches there are now six regional audit centres.¹² These centres hold direct responsibility to the BOD, and remuneration and appointment of internal auditors are determined by it. In this way, internal auditors can be insulated from the underlying pressure and/or motivation for prescribing a particular outcome or recommendation. The existent organizational and personnel resources enabled the more independent supervisory function to quickly come into being, thus changing the previous superior-subordinate relationship between internal audit units and regional branches. The director of Southern China Shenzhen Audit Centre here commented on the positive effects this organizational change brought thus:

"The directors of the regional (audit) centres hold the same administrative rankings to the general managers of provincial branches. Thus, our (internal) auditors can be isolated from the political interference from provincial and municipal branches. The uncovered managerial misconduct and accounting irregularities can be directly reported to the audit committee by regional auditing executives in an unrestricted manner" (IN23, 2011).

In addition to this organizational change, internal audit staffs are tacitly mandated to rotate in a 2-4 year interval. According to a BOD statement regarding recent personnel rotation, "the movement of internal audit staff facilitates the communication of audit experience among the regional centres and thus helps to develop a better understanding of risk control among the corporate managers". Another and perhaps more important consideration underlying the rotation of internal auditors is the fear that the over-long tenure of regional auditors may generate a localism where auditors abuse their supervisory powers given local interest and their personal networks. In contrast, through regular personnel redeployment, shorter tenured

¹² They are: North-Eastern China Shenyang Audit Centre, Northern China Beijing Audit Centre, Eastern China Shanghai Audit Centre, Southern China Shenzhen Audit Centre, North-Western China Xi'an Audit Centre, and South—Western China Chengdu Audit Centre.

auditors have less incentive to collude with branch management and thus reduce the risk of insider entrenchment.¹³ A senior member of the audit committee thus added:

“The BOD has mandated that a cross-regional audit scheme should be conducted on a seasonal basis. In this way, the regional (audit) centres are left with even less incentive to conceal any frauds and irregularities under their jurisdictions” (IN19, 2010).

The statutory and structural improvement of internal audit also challenges internal auditors' expertise. In the discussion of the initial impacts of financial crisis on the insurance industry, international regulatory bodies, including OECD and the Geneva Association, suggested that the direct exposures to the crisis for most insurers have been relatively limited compared with their banking counterparts. Insurance sector representatives regularly emphasize that the ongoing economic upheaval is primarily a banking crisis which does not threaten the solvency of the insurance sector as a whole (Schich, 2009). Nonetheless, as the crisis spread, insurance companies have encountered certain adverse effects. Their exposures to unexpected return reductions have come primarily through their investment portfolios (Schich, 2009). This is because insurance companies' assets are generally held in bonds and stocks. It is against this background that expertise of internal audit and risk control has become the focus of international regulators and business practitioners. In the introductory section about the internal auditing profession, the Institute of Internal Audit (2011, p. 6) (IIA) specifies that “the audit committee should comprise independent non-executive directors, at least one of whom has significant accounting or related financial management expertise”. Financial expertise here refers generally to the specialised skills “in the arena of financial reporting, corporate governance, and internal control” (IIA, 2011, p7).¹⁴ Having such skills arguably “helps to ensure more effective management oversight, fosters financial statement accuracy and transparency, and places an appropriate focus on business risks and internal controls” (IIA, 2011, p. 7). To perform effective fraud detection and risk control requires specialist financial expertise in addition to organizational independence.

¹³ In fact, the personnel rotation has conventionally been an important form of the CCP's cadre management. In 1990, "The Decision of the Central Committee of the Communist Party about Rotation Party Leaders and Government Leaders of China" mandated that provincial levelled cadres should be rotated among the provinces or between the provinces and the departments in the central governments. In 1999, a document named "The Temporary Regulation for Rotating Party Leaders and Government Leaders" had been promulgated and provided a detailed instruction about implementing cadre rotation. Later in 2006, such a temporary document has become a formal regulation. It requires that the cadres, who have been working in a region for a long time, for example 10 years, should be reallocated in order to increase their working experience. The personnel rotation scheme should be implemented among regions, governmental departments, as well as SOEs.

¹⁴ Specified requirements about auditor' expertise are not found in the Sections of SOX. Instead, great emphasize has been placed on ensuring the independence nature of internal auditing.

In 2009, the BOD elected an independent director as the Chairman of the Audit Committee, one with extensive actuarial work experience with Ernst & Young. It was the first time that the audit committee head had been a financial specialist since its establishment. The deputy director of Southern China Shenzhen Audit Centre here commented:

“The audit committee for a long time had been regarded as rubber stamp... The increasingly intensified competition and more stringent regulation suggested that the committee needed a qualified leader with in-depth knowledge of both, who had studied the insurance industry as well as accounting and other issues relevant to the industry. From this point of view, Mr Moore was the perfect candidate” (IN24, 2011).

For an insurance giant with a vast geographical base, the efficacy of its internal audit system relies largely upon the effective functioning of grass-root audit units. The deputy director of a regional audit centre further explained:

“Proper familiarity with the insurance business is a critical attribute of an effective internal audit system. We have come across several similar cases where local managers required their staff to buy certain insurance policies in order to fulfil the monthly business quota designated by their superiors. These policies will be surrendered sometime in the future. In this case, attention must be paid to the changes in cash flow and cancellation rates. Without a solid understanding in the relevant financial and business procedures, these frauds may be well concealed” (IN20, 2011).

Senior officials of the NAO echoed this point of view:

- *“Conventionally the role of internal audit has been limited to ex post fraud detection. However, a well-functioning internal audit system will certainly play an effective role in supervision and warning against managerial malpractices ex ante”*(IN35, 2010);
- *“In other words, the internal audit system should not be limited to play a detective role. To achieve this, the internal audit system must undergo a comprehensive change in the fonts of both ‘structure’ and ‘quality’”* (IN36, 2010).

Elsewhere, more stringent solvency requirements in the insurance sector reflect growing concern about capital inadequacy in the banking sector. This has been reflected by Basel II with more emphasis on refined differentiation between different risk profiles and increased reliance on incentives for internal risk management (KPMG, 2009). In China, the

requirements of insurers' capital adequacy remain at a relatively low level. In the light of declining asset prices and investment returns, the focus of China Life's internal audit progressively shifted towards more comprehensive *ex ante* risk appraisal, away from conventional *ex post* accounting verification. While observers deemed the Company's solvency risk relatively low, China Life's executives and internal auditors had more nuanced understanding:

- *“According to the solvency requirement of CIRC, China Life has always been regarded as ‘capital adequate’. On the one hand, this is mainly because of less stringent requirement regarding capital reserves for domestic insurers. Otherwise, a more important reason is that the investment portfolio and products structures for domestic insurers are not as complicated as for our western counterparts, implying a relatively lower financial risk” (IN1, 2009);*
- *“As the current foreign-reserve administration system is highly centralized, insurers have to apply for the quotas issued by the State Administration of Foreign Exchange. All these have considerably limited our investment channels. However, this does not mean the Company is not exposed to any significant market risk. With an increasing number of investment instrument approved by CIRC, the investment channels will be significantly enlarged. This inevitably impose the new challenge on the risk management of China, in particular, its internal control system. Correspondingly, the role of internal audit must further be incorporated with the Company's business and investment strategies” (IN1, 2010);*
- *“The insolvency risk (of a life insurer) derives also from its product structure. During our recent cross-regional audit, we have found problems of cash shortage in some provincial branches. For example, the cash reserve of Guangdong provincial branch declined significantly. For a province with the highest sales income, the problem of cash shortage sounds inconceivable”(IN21, 2011);*
- *“Along with the rapid increase of asset, there is always a significant rise in obligations. Thus in the pursuit of the expansion of market share and asset size, senior executives have to be cautious about whether the capital reserve, in particular the cash reserve, can match the pace of business expansion”(IN20, 2011);*

- *“For years, the premium income of most provincial branched displayed M-shaped pattern, which causes similar patterns of claims payment as insurance policies approach their expiry date. The uncovered cash shortage is mainly attributed to the sudden increase in claims payment and irregular premium growth model” (IN19, 2010);*
- *“For top decision-makers, factors such as investment return trends, premium growth model, as well as the incentive structure for regional business units must be jointly considered”(IN23, 2011).*

Such improved independence and business expertise significantly enhanced the efficacy of China Life’s internal audit. Over 2010, internal audit units have detected more than 200 financial irregularity problems related to sales and marketing, product structure, agency business, claim payment, and accounting recording (IN19, 2011; IN23, 2011). As to liquidity and risk control, the company’s solvency capability ratios remain on average 86.5 per cent higher than the regulatory requirement over the period of 2008-2012. While persistent low investment returns have caused severe cash pressure for most domestic life insurers, solvency capabilities of China Life experienced a steady increase of 11.3 per cent over the last three years. Table 6.3 presents changes in China Life’s solvency margin in comparison of its major peer competitor, i.e. Ping An Life Insurance. As noted by executives, the shifting from “sales expansion” to onto “perfecting product structure and asset quality” has led to the decelerated premium growth (IN1, 2011; IN16, 2011; IN21, 2011). Nevertheless, China Life’s capital adequacy ratios remain consistently higher than other domestic life insurers, including China Pacific (211 in 2012) and New China Life (192.56 in 2012). While other insurers are planning to ease the capital strain through share and debt sales, China Life repeatedly asserted “its cash reserve is enough to fulfil the radical rise in repayment” (China Life, 2012). This is largely attributable to improved risk control and asset quality (IN5, 2012). As stated in the minutes of the annual general meeting, “the corporate governance level has significantly improved in recent years with the audit committee that is more active and diligent and possessing greater expertise and power to fulfil its responsibilities”.

The Company’s continuous efforts in improving governance practices received positive recognition from both legal professionals and market participants. In the “Most Valuable 500 Chinese Brands” survey jointly conducted by the World Brand Laboratory and the World Economic Forum in 2006, China Life was among the Top Ten Most Valuable Brands in China for six consecutive years. In 2007, China Life won the Hong Kong Corporate

Governance Excellence Awards founded by the Chamber of Hong Kong Listed Companies and the Centre for Corporate Governance and Financial Policy in Hong Kong Baptist University. In the “Asia Best Companies 2009” organized by Finance Asia, the company was given with the Best Corporate Governance and Best Investor Relation Awards. Mrs Wu of Debevoise & Plimpton LLP thus commented:

“Although Section 303A.07 of the NYSE Listed Company Manual does not specify the requirements regarding the independence and power of internal audit for foreign listed companies, the perceived independence of China Life’s audit system has significantly improved the reliability and validity of (internal) audit findings. The business misconducts revealed recently against US-listed Chinese companies have once again put the reliability of their financial information under the governance spotlight. The improved independence of the internal audit units certainly would help the Company regain investors’ confidence” (IN31, 2010).

In December 2012, the China Institute of Internal Audit awarded the prize of “internal audit leader” to China Life “by virtue of its innovative organizational design and outstanding audit efficacy” (China Life, 2012). The case here highlighted how Chinese SOEs claim to improve internal audit practices. Since early 2000, internal audit reform had accelerated across the state sector largely due to growing concern with risk and transparency for investors and regulators (China Institute of Internal Audit, 2012). It is increasingly acknowledged that effective internal audit plays a key role in assisting the BODs to discharge its governance responsibilities, particularly in risk control and fraud detection (KPMG, 2009).

Table 6.3 Solvency Margin Ratio of China Life (per cent)

Year	China Life		Ping An	
	Solvency Margin	Premium Growth	Solvency Margin	Premium Growth
2012	235.58	0.16	190.6	26.15
2010	211.99	12.15	180.2	28.82
2008	310.00	5.77	183.7	-4.89
2006	350.00	13.11	183.1	32.46
2004	315.00	-2.28	123.1	-3.62

Source: China Life and Ping An Annual Reports (2004, 2006, 2008, 2010, and 2012)

6.5.4 Assessment by International Investors and Implication

Unlike board institutions, improved internal audit in China’s state sector has largely been driven by competitive pressure and firms’ imperative for risk control. In China Life, both it

and regulators have identified particular risk factors associated with rapid business expansion and market volatility. As noted, the quest for an effective risk control system brought a noticeable shift in the norms guiding audit activities, from the “conventional compliance audit” towards “performance audit” in which “more attention is accorded to actual performance or outcome, rather than simply the legal compliance and regularity of financial activities” (Gong, 2009, p. 27). Notably, the empowerment of internal auditors has been underpinned by a series of organizational changes, which transformed the system from the subordinate units of corporate management to perform more independent appraisal and supervision. With increased expertise, a more preventive and corrective role of internal audit became possible.

Using the same raw data set outlined in Chapter 5, the following quantitative analysis examines how international investors judge the efficacy of the board and audit practices mentioned above. The explanatory variables of board independence (BI), supervisory board size (SBS), and audit committee independence (ACI) are now included as proxy for the efficacy of different CG practices. First, it is argued that independent directors should be motivated to work in the best interests of minority shareholders as they bear substantial reputation costs if they fall short in their duties (Fama and Jensen, 1983; Srinivasan, 2005). In the context of CM&As a higher degree of board independence would provide effective defence against the excessive risk taking and exploitative behaviour by the controlling shareholders and directors (Hu et al., 2010). Moreover their expertise and external knowledge may provide the essential advice and resources that are particularly appropriate for overseas expansion (Hillman and Dalziel, 2003; Yoshikawa and McGuire, 2008; Hilman et al., 2009). Both the agency and resource-based perspectives endorse the important role of independent directors in safeguarding and maximising shareholder interests (Denis and McConnell, 2003; Gillan, 2006; Luan and Tang, 2007). Secondly, under China’s two-tier board system, supervisors do not participate in the decision-making or the voting process but are designated to monitor the board of directors. They are responsible for scrutinizing decisions made by directors, reviewing and auditing the reports provided by directors, and resolving any disputes arising between shareholders and directors. A large SB is more likely to resist managerial malpractice, and improve the informativeness of public investors in major decision-makings (Yeh and Woidtke, 2005; Firth et al., 2007). Finally, prevailing CG research also suggests that independence of an audit committee, as measured by the proportion of independent auditors, can play a positive role in disciplining incumbent

insiders (see Chan and Li, 2008). It allows auditors freedom from the influence and pressure of corporate management and thus avoids potential conflicts of interest (Kalbers and Fogarty, 1998; Lin et al., 2008). Such monitoring is expected to increase shareholder gains for acquiring firms, as presumed independence can ensure that investment decisions are suitably aligned with the interests of public investors. It therefore seemed reasonable to expect a positive correlation between the cumulative abnormal returns (CARs) and CG practices of the acquirers. Likewise, the CARs are used to infer how public investors regard the observed CG practices among Chinese MNEs. In the meantime dummy variables of group affiliation (GA) and CEO duality (CD) are included as proxy measures of potential insider entrenchment, for problems of insider control and the associated expropriation risk remain the major concerns for public investors in the Chinese context (Sanders and Carpenter, 1998; Khanna and Palepu, 2000; Kim and Yi, 2006). Table 6.4 presents the key statistical findings.

Table 6.4 Announcement Returns and Board Practices

	Model 1	Model 2	Model 3	Model 4	Model 5	Model 6
Audit Committee Independence			0.000248* (0.000138)			0.000254* (0.000141)
Supervisory Board Size		-0.00173 (0.00108)			-0.00189* (0.00113)	
Board of Directors Independence	-0.000140 (0.000522)			-0.000127 (0.000507)		
CEO Duality				-0.00149 (0.00750)	-0.00508 (0.00806)	-0.00312 (0.00794)
Group Affiliation Dummy	-0.0103 (0.00806)	-0.0122 (0.00773)	-0.0160* (0.00818)	-0.0103 (0.00806)	-0.0125 (0.00749)	-0.0162** (0.00805)
Firm Age	-0.000595** (0.000239)	-0.000713*** (0.000269)	-0.000473** (0.000237)	-0.000599** (0.000237)	-0.000743*** (0.000273)	-0.000481** (0.000234)
Firma Size	-0.00455*** (0.00166)	-0.00292 (0.00189)	-0.00406** (0.00162)	-0.00454*** (0.00165)	-0.00276 (0.00190)	-0.00404** (0.00162)
Return on Assets	-0.00192*** (0.000522)	-0.00191*** (0.000506)	-0.00194*** (0.000513)	-0.00190*** (0.000529)	-0.00184*** (0.000520)	-0.00190*** (0.000525)
Tobin's Q	-0.00255*** (0.000860)	-0.00235*** (0.000812)	-0.00253*** (0.000848)	-0.00253*** (0.000858)	-0.00226*** (0.000825)	-0.00248*** (0.000854)
Debt-Equity Ratio	-2.16e-06 (3.04e-05)	-1.52e-06 (3.16e-05)	3.38e-06 (3.19e-05)	-2.20e-06 (3.04e-05)	-1.91e-06 (3.13e-05)	3.27e-06 (3.18e-05)
Operating Profit Margin	0.000384*** (8.48e-05)	0.000352*** (8.31e-05)	0.000397*** (8.50e-05)	0.000382*** (8.58e-05)	0.000346*** (8.54e-05)	0.000396*** (8.64e-05)
Target Status Dummy	-0.00543 (0.00694)	-0.00467 (0.00670)	-0.00406 (0.00662)	-0.00543 (0.00694)	-0.00475 (0.00667)	-0.00410 (0.00659)
Constant	0.0694* (0.0407)	0.0486 (0.0330)	0.0531 (0.0320)	0.0693* (0.0407)	0.0484 (0.0331)	0.0536* (0.0320)
Observations	372	372	372	372	372	372
R-squared	0.116	0.123	0.122	0.116	0.124	0.123

Robust standard errors reported in parentheses, *** p<0.01, ** p<0.05, *p<0.1

The negative coefficients of BI and SBS here suggest the perceived inefficacy in safeguarding investors' interests during investment decision making (see Xi, 2007; Tomasic, 2010). In opting for stylized features of the Anglo-American model of corporate governance, policy makers and executives attach particular importance to the structural and/or formal compliance while neglecting such 'soft' issues as appropriate informal institutions and constituency base (Tam, 2002). However, as noted above, effective functioning of transplanted CG mechanisms has been hindered by the social-political environment in which they operate (Peng 2004; Xiao et al., 2004; Ning et al., 2014). Under concentrated ownership independent directors simply lack *de facto* power of veto over ill-advised investment projects (see Byrd and Hickman, 1992). Moreover, with a shareholding group acting as the *intermediate principal*, the pool for key executive positions is restricted and subject to bureaucratic influence from the intermediate layer (Jefferson et al., 2003; Naughton, 2006, 2008).¹⁵ For Tomasic (2010) board members in China's SCCSs generally lack the sense of fiduciary obligations to shareholders given the legacy of superior-subordinate relation between the shareholding companies and listed entity. Thus objectivity and business acumen of independent directors are unduly impaired, though they are deemed particularly important in monitoring the acquisition process when managers' empire-building ambitions or executive pride conflict with investors' interests (Byrd and Hickman, 1992). The case of China Life suggests that institutions of independent directors (as well as supervisors) may be further purposefully manipulated as leverage to entrench vested interests, and thus did not discharge their full governance responsibilities. In the context of CM&As, such collusion encourages corporate insiders to pursue their self-interests at the expense of public investors (Bontin, 2001; Lien et al., 2005; Ning et al., 2014).

As noted, Chinese supervisory boards are often staffed with retired bureaucracies and incumbent managers. Such a constituency base of supervisors suggests a general lack of expertise for effective business monitoring and investment decision-making. It is claimed that Chinese SBs are merely playing a "window dressing" or "rubber stamp" role (Shan and Xu, 2012, p. 20). For public investors the expanded size is likely to incur significant coordination costs to investment decision making and operation (see also Xi, 2007). The negative and significant coefficient of SBS (Model 5) confirmed the perceived expropriation risk and cost. In contrast, the coefficients of ACI are positive and statistically significant in every

¹⁵ In China Life, board members generally lack the sense of fiduciary obligations to shareholders given the legacy of superior-subordinate relation between the Group Company and listed entity.

specification (Model 3 and Model 6). The narrative account suggests that reform of internal audit has gone beyond structural compliance, and adopted a more comprehensive approach that integrates significant organizational and cognitive reorientation (see also Yi et al, 2012). Although mainland stock exchanges provide no mandatory requirement regarding ACI, international investors assume an increasingly critical role for the audit committee in risk control and restricting malpractices (Vijayakumar and Nagaraja, 2012). Where emerging MNEs are characterised by unsophisticated markets, and limited exposure to global competition, effective and independent internal audit systems provide assurance against risk associated with international expansion (Ramamurti and Singh, 2009; see also Du and Boateng, 2012). The beneficial effects of improved ACI in Chinese MNEs can be inferred through the positive market reaction on CM&A announcements.

To summarize, the on-going reforms of China Life reflected the state's continuous manoeuvring in curbing managerial entrenchment and fostering a globally competitive insurance giant. In this process, effective ownership rights and national interests constituted the major policy imperatives. The rising economic and political influence of the Group Company exacerbated the agency problems by weakening the control of the ultimate principal, its paternalistic control further led to the rising tension with the listed company. These vested interests, coupled with the absence of complementary institutions precluded the possibility for more structural changes in the near future. Faced with these challenges, central policymakers, driven by economic and legitimacy concerns, became leading change agents across different SSG domains. They chose to revise and reinterpret the evaluation criteria for executives and/or state cadres in order to shore up their political oversight function and to accommodate the competitive pressure. What was clear was that the previous nomenklatura framework facilitated the transformation even as the framework as a whole remained remarkably stable. In this process, the state audit apparatus provided the latent resources – structural, procedural, and personnel – that the central policy makers were able to utilize for imposing more effective monitoring. Likewise, the Company's internal auditors exploited the linkages within existing governance frameworks to establish new procedures and mechanisms that would achieve more effective risk control. The empowerment of internal audit function received broad recognition from international capital markets. In this regard, policy makers and corporate strategizers have gone beyond the technical and administrative to the more market oriented initiatives to induce systemic changes.

6.6 Summary

This chapter provides firm-level evidence regarding the transformative dynamics of the SSG system by exploring the role and political skills of relevant stakeholders, in particular central policy makers and corporate strategizers. The qualitative narrative account explains the remarkable transformation of China Life's governance system – from centralized administrative control towards a coordinated governance model with increasing emphasis on profit and risk monitoring, and from serious initial scepticism towards substantial improvements receiving outside recognition. Broad consensus over such matters as political stability and state ownership control ultimately crystalized important features of the state-centric governance system. Hence, the reflectivity and institutional capability of policy makers and other strategizers played a key role in the enterprise reform. Where initial reforms often began with cognitive reorientation among key stakeholders, the success was also subject to the availability of indigenous structural and personnel resources. The findings here contrast significantly with the monolithic and static view of state-centric model in the prevailing finance-accounting literature.

However, progress in governance improvement brought significant side payments; the resultant vested interests in turn constituted the major obstacles for further reform. The radical displacement of modern governance institutions proved to be a poor fit with the socio-cultural context in which the governance system operates, as inferred from the mediated efficacy of board institutions (see also Jing and McDermott, 2012). Nevertheless, as increased capital market pressure and regulatory stringency brought further reform drives, skilled strategists exploited existing governance frameworks and personnel to orchestrate a series of organizational changes despite the constraining factors. The reforms have been substantial and are still ongoing, involving significant changes in regulatory frameworks, business practices, and cognitive reorientation of participants. Given the changes in market conditions and the corporate landscape, strategists have shifted focus from notional structural compliance towards more comprehensive institution building aiming at more effective internal control and shareholder protection. The complementary statistical inference further confirmed that reforms based on endogenous imperatives and existent resources are more likely than structural compliance to bring in essential and meaningful improvement in governance practices. For Mahoney and Thelen (2010), the final policy outcomes reply upon the complex interaction of change agents with changing social-economic conditions. Thus,

the next chapter uses the path-based approach to discuss the transformative mechanisms and/or strategies adopted by different social actors.

Chapter 7

Discussion: Path-Generation Explanations on China's State Sector Governance

7.1 Introduction

This chapter employs a path-based approach to explain the evidence about the reform of Chinese state sector governance (SSG) while also reflecting upon the essential methodological issues raised by doing the necessary high level fieldwork, in situ, with elite actors. It is organized as follows. Section 7.2 reprises the dynamics of reform with particular reference to the different institutional settings, reform drives, change agents, transformative skills and eventual policy outcomes. Section 7.3 summarizes the key research findings in regard to the original research propositions. Section 7.4 then discusses the methodological implications of using a path-based approach for these purposes. It suggests that an approach that focuses on the dialectical interactions between situated actors and wider meta-institutional contexts over time can be useful in understanding institutional change processes (Bell and Feng, 2013).

7.2 Dynamics of China's SSG Reform

Using the lexicon of path generation, Tables 7.1 and 7.2 summarise the key findings at both national and firm levels respectively. They show how political-economic settings, reform drives, change agents and their transformative skills influence eventual SSG practices and/or patterns. These include entrenched managerial interests and the regulatory state as well as rising, but still limited, public investor influence. Changed political-economic settings and actors' strategies both influenced how Chinese SSG evolved (Wu, 2005). To frame these observations more generally: the gradual expansion of market mechanisms and specific institutional characteristics are jointly shaping the type of transformative dynamics expected. The varying tensions and pressures for change across different institutional spheres determine which types of change agents most likely emerge and flourish, as well as the strategies they choose to effect transformation (Wu, 2005; Streeck, 2009; Mahoney and Thelen, 2010, p. 15).

As noted, Chinese authoritarian political institutions are stable enough to matter, but not so much that "path dependence can carry the entire explanation" (Slater, 2010, p. 164). Consequently, institutional analysis of SSG must expect not "order in equilibrium",

Table 7.1 Transformative Dynamics at National Level

Events	Political-Economic Setting	Reform Motivation	Change Agents	Reform Measures	Strategies	Policy Outcomes
Initial enterprise reform (1980s)	The periodic chaos of central planning	Unsustainable development model, economic and legitimacy concerns	The reformist leadership, local governments, and enterprise managers	Power delegating, profit sharing, and contract responsibility	Layering/experimentation, coalition building	Expanded enterprise autonomy created newly vested interests. Asymmetry between power and responsibility remained unaddressed.
State sector restructuring (early-1990s)	Marketization and restoration of reform drives after political upheavals	Mounting fiscal burden of fiscal subsidies and limitedness of initial reform	The reformist leadership, local governments, and enterprise managers	Fiscal decentralization and “grasping the large, letting go of the small”	Coalition building, converting, and layering/experimentation,	Authority relationships between the central and local governments were clarified; reform drives were continued.
Administrative streamlining (early-1990s)	Deteriorating state-owned enterprises’ (SOEs) performance and ideological breakthrough	Separation of enterprise from government intervention	The reformist leadership, line ministries, and enterprise managers	Promulgation of the Company Law and transformation of ministries into shareholding groups	Converting and compromising	The ministries were transformed into shareholding groups while allowed to retain their ownership control. Bureaucratic interests were perpetuated.
Corporatization (mid- and late-1990s)	Increased marketization, entry of World Trade Organisation (WTO), and financial market development	Making SOEs truly independent by imposing modern governance institutions	The reformist leadership, shareholding groups, and enterprise managers	Asset split-off, introduction of board institutions, overseas share listings, and set-up of regulatory bodies	Converting, layering, displacement, and ad hoc measures	Modern corporate governance (CG) institutions were formally enacted. Enterprise autonomy was enhanced. Insider control problem started to emerge. Influence of public investor remained weak.
Reconsolidation of state ownership rights (early-2000s)	Economic growth, rising corporate power, further development of financial market, and the transition of state role in governing economic activities	Recentralizing its fiscal resources to implement other reform schemes, addressing the insider control, maintaining financial market development	Regulatory and supervisory bodies, party committees, and public investors	Dividends remittance, “two-way intervention”, reorientation of managerial evaluation	Increased institutional openness, converting and drifting	The party-state is pursuing to regularize and institutionalize more professional oversight over corporate insiders. Influence of investors emerges.

Table 7.2 Transformative Dynamics at Firm Level

Events	Political-Economic Setting	Reform Initiatives	Change Agents	Reform Measures	Strategies	Policy Outcomes
The settlement of the spread loss problem	Legitimacy concerns, limited fiscal capacity, and initial public offering (IPO) timing	Declining fiscal income and major spread loss	The State Council, China Insurance Regulatory Commission (CIRC), and the Ministry of Finance (MOF)	Spinning off non-performing assets, administrative cooperation, and administrative restructuring	Experimentation and ad hoc approaches	The listed company consisting of high quality assets obtained IPO success, while leaving the transparency concerns unaddressed.
Class action lawsuit	The complexity of spinning off, impossibility of structural reform	Major financial loss, prospect of SOE overseas listing, and legitimacy of state-led restructuring	CIRC, the MOF, the executives, international investors and regulators	Administrative cooperating and voluntary information disclosure	Increased institutional openness and ad hoc approaches	A higher standard of information disclosure gained widespread recognition from international investors.
CG institutions	Ownership concentration	Regulatory compliance	“Leading team” members and incumbent managers of the Group Company	Structural compliance with transplanted mechanisms	Displacement and converting	The rubber stamp role of the boards suggests that the efficacy of these governance mechanisms was largely mediated, and utilized by corporate insiders to serve their sectional interests.
The improvement of party control efficacy	Legitimacy of the Chinese Communists Party (CCP) control and ideological challenge from marketization	Increasing insider control	CCP Central Organizational Department, CIRC and the National Audit Office (NAO)	Cognitive changes in evaluative criteria and craft coalition with regulatory bodies	Converting	More institutionalized and effective control by the party-state against entrenched sectional interests.
Developing internal audit	Organizational defects and lack of independence	Regulatory compliance and inherent business risk	CIRC and the executives	Utilizing existing internal audit resource	Displacement and converting	A more independent and effective internal control plays an increasingly important role in corporate decision-makings.

but what Beckert (1980) termed “dynamic disequilibrium” (see also Streeck, 2009, p. 246). These findings here also suggest that the character of SSG is not necessarily determined by a collective and consensual quest for increased efficiency as orthodox neoclassical economics might imply. It can instead be an outcome of struggles between increased market and competitive pressures, and demands for maintaining extant governance structures and related vested interests. The former represents no less legitimate and also, in principle, no less urgent concerns for policy makers and key actors than the latter. Reducing actual socio-economic embeddedness to technical-economic calculations about competitive performance here misses both the redistributive nature of Chinese SSG and the mediated efficacy of transplanted mechanisms. The distinctive features of Chinese SSG reform can now be summarized thus:¹

Deinstitutionalisation of Centrally-Planning and Reform Emergence (Propositions 1 and 4): Over three decades, legitimacy concerns and efficiency imperatives have constituted the main parameters of SSG reform. Like other social institutions, SSG emerges as a product of its particular political-economic setting, reflecting the prevailing developmental strategy at a certain point in time (Dacin et al., 2002). The chronic shortcomings in China’s SSG system have been rooted in closely woven institutional arrangements across various different domains, and have repeatedly questioned particular governance practices and/or reform measures, producing “a web of vulnerability” which destabilizes the wider economy in ways which bring the legitimacy of central leadership into question (Seo and Creed, 2002, p. 227). For the party-state, the state sector simply has represented such a vast patronage system that any performance deterioration therein directly erodes the loyalty of its key constituencies. This accentuated differences among leading actors and exacerbated the decoupling of the extant SSG until other potentially innovative but initially experimental reform schemes duly emerged.

Power delegation and corporatization both illustrate how legitimacy-driven pressures associated with performance deterioration provide particular impetus for reformist leadership to question the existing state-enterprise relationship and adopt increasingly market-oriented programs in respect of enterprise autonomy, managerial incentives, and ownership structure. Measures taken prior to the official corporatization programme can be viewed as intermediate steps towards expanding market mechanisms and decentralizing decision-

¹ The propositions each analysis may respond to are stated in the pantheists.

making. The multiple connections among components of SSG institutions mean that changes in one domain will affect other parts of the system. The problems and resultant legitimacy concerns opened “cracks” in the “monolith” of the socialist economy, by which cumulative forces eventually took over amid further splitting and contention (MacMillan and Naughton, 1992). SSG transformation reflects the “gradual historical exhaustion” of traditional administrative planning, and the quest of the party-state to improve efficiency in the midst of economic patronage (Streeck, 2009).

At firm level, although changed economic conditions and regulation may not directly threaten change agents, they nevertheless invite negative-feedback effects about prior governance practices which help bring about their eventual demise. As shown by class-action lawsuits, international listing here caused fundamental tensions between the state-led or dominated corporatization model and the market-oriented governance system. Recent reform initiatives, including improved information disclosure and curtailed non-monetary benefits, indicate more willingness to provide for investor protection. Meanwhile, reliance upon ideological compliance and/or loyalty make conventional political oversight even less effective during accelerated marketization. Despite an impressive network and enduring *nomenklatura* hierarchy, there are still possibilities of transformation. The initial institutional deviation may take the form of organizational rearrangements (e.g. the invention of “two-way intervention”), or the cognitive reorientation of change agents (e.g. increasing emphasis upon profit and efficiency in cadre evaluation). Innovative policy options and practices are likely to emerge from governance elements under challenge. As internal audit development demonstrates, the accelerated growth of mainland insurance markets and regulatory enforcement questions how feasible the director responsibility system really is.

Layering and Political Constraints (Propositions 2, 3 and 4): Processes of layering often occur when reformers lack the necessary political power and financial ability to overturn previous governance institutions. While defenders of the status quo can oppose and prevent radical displacement, they are still unable to prevent new practices being brought in alongside the old rules. This was particularly so during the initial stage of SOE reform. Political opposition stemmed largely from the socialist orthodoxy which stressed the dominance of state ownership and superiority of central planning. With progressively dismantled central planning the politics of corporate restructuring changed enough to invite new lines of defence among key power groups. Containing the social repercussions of

corporate restructuring and dampening ideological controversy were part of the policy makers' agenda from the very beginning of SOE reform. Against this background, SOE reform – as in most domains of China's economic transformation – has occurred in a dual-track manner whereby innovative, often experimental measures have been introduced or “layered” in parallel with prior institutional arrangements. Instead of displacement, layering becomes a more promising strategy of change in a political environment where there are strong veto players (Mahoney and Thelen, 2010). First implemented as an institutional addition, these policy innovations erode the legitimacy of entrenched institutions of centralised planning while generating support for reform by creating “newly vested interests”. In this context, the (previous) fragmentation of enterprise authorities provides central policy makers with an opportunity to fine-tune different reform initiatives (Saich, 2011).

From 1978 to the mid-1990s, recurrent reform experimentation or fiscal decentralization resulted in “protracted policy tinkering with bureaucratic and financial incentives or formal corporate reorganization, yet without touching the politically protected and financially privileged status of SOEs in the economy”. More market-oriented practices enabled coalitions among vested interests or/and reform beneficiaries which gradually eroded the prominence of veto players.² Layering can also be regarded as experimental reform. Various market-oriented schemes were first experimented with before being expanded in the name of “maintaining the superiority of socialist institutions” (*weihu shehui zhuyi zhidu de youyuexing* in Chinese). In this process, fragmented authoritarianism inherited from the centrally-planned era “allowed the implementation of innovative programmes in politically distinctive and territorially bounded regions” (Mahoney and Streeck, 2010, p. 57). Localities provided the test bed for emerging administrative and business practices where novel policy options were fed back into national policymaking to provide the basis for broader reform departures. In this way, particular policy deadlocks could frequently be overcome and experiments expanded “far beyond what could have been accomplished by top-down initiatives dependent on political consensus” among party leaders (Rawski, 1995, p. 1162; Heilmann, 2011, p. 113).

² For Stark et al. (1989), the great uncertainty of changing corporate institutions forces the reformist leadership to form a political coalition in order to keep enterprise reform on the agenda. Crafting coalition requires the compromise that allows the coexistence of two seemingly contradictory institutional configurations.

Conversion and Exploiting Extant Institutions (Propositions 2, 3 and 4): Change agents, such as reformist leadership and new regulatory bodies, often exploit extant institutional resources in order to reduce the opposition to, and uncertainties of, innovative policy options. This tactic enables them to progressively convert certain existing institutions, “even subverting its purposes, while still following them to the letter” (Sheingate, 2010, p. 185). This permits expanded reform initiatives. In the case of “grasping the large and letting go of the small”, the criss-cross governance framework developed by central and local bureaucracies re-asserted authority over parts of the state sector: local government in particular reclaimed control over small and medium-sized SOEs while central government reconsolidated its authority over large corporations.³ For Yeo (2013), central government seeks more feasible but not necessarily the best ways to “accommodate” market-oriented government institutions with prevailing political-economic realities, and thus creates its own preferred corporate governance regime. The enhanced power of independent directors and the norms of two-way intervention demonstrate how mechanisms transplanted from other market-oriented governance regimes have been carefully “orchestrated” or “converted” to institutionalize such political oversights and this further enhances the State Asset Supervision and Administration Commission’s (SASAC) own regulatory regime.

Moreover, despite continued *nomenklatura* based personnel control, evaluation criteria for SOE managers have become increasingly market-oriented, reducing earlier ideological compliance. Central government has redefined its role from general administrator of the state sector to “the representative of state interests as an investor and ‘owner’ of state asset” (Jung, 2011, p. 131; see also Naughton, 2007). This requires the party-state to limit the scope of its control by withdrawing from non-key industrial sectors while also introducing better monitoring of SOE management. In such cases, policy changes have sought to re-orient extant institutions according to central government’s reform vision, even though the formal attributes of these institutions remain largely intact.

Displacement and Contrasting Effects (Proposition 2 and 4): Displacement mechanisms are not often observed in the development of China’s SSG system. This would have involved the radical and sudden substitutions of previous rules, which could invoke opposition from vested interests. When boards of directors and supervisors were *transplanted* into China Life, they were intended to replace the “old three committees” as new governance bodies,

³ Such a fragmented governance framework was once designated for implementing planning directive and mobilizing political campaigns.

and to further distance government intervention from detailed enterprise operation. Under concentrated ownership structure (more than 70 per cent of shares held by the Group Company), efficacy of these “modern enterprise institutions” has been largely mediated and further manipulated by entrenched insiders pursuing their own interests. Agents from quasi-administrative agencies have their own considerations and may challenge reformist leadership at particular junctures, as the limited success of state ownership consolidation and investor protection measures demonstrates. Confronting market-based CG mechanisms in a bureaucratic-centric environment questions whether a fully functioning CG system comparable to that found in civil and common law countries is really feasible and likely to restrict economically detrimental rent-seeking (see Braendle et al., 2005). Statistical findings here confirm that transplanted governance mechanisms do not really achieve their expected goals. In contrast, promulgation of internal audit systems goes beyond mere formal or statutory compliance, being largely driven by central policy makers’ economic imperatives. This has brought more substantive changes in managerial conducts which are positively confirmed by market participants. The contrasting results of two transplanted institutions highlight the central role of endogenous factors in generating meaningful improvement in governance practices, including risk control awareness, qualified personnel with business expertise, and extant organizational structure. Transnational policymakers should be careful when importing so-called “best practices” when such essential conditions are absent.

Ad Hoc Measure without Complementary Institutions (Propositions 2, 3 and 4): While the Chinese party-state is able to bring critical resources to embark upon selected reforms within a limited period of time, it often employs an *ad hoc* approach to address the problems of implementation and follow-up. Insights from the VoC literature underscore the need to consider institutional support for developing corporate governance systems. The degree to which institutional complementarities exist affects the efficacy of the governance system and the lack of appropriate institutions itself limits the achievable goals. In the Chinese case, transplanted CG mechanisms provide notional structural compliance which entrenched insiders can still potentially circumvent.

Nevertheless the evidence here suggests that, when central policy makers can determine the sequencing of reforms, this may help mediate, if not mitigate, the lack of complementary institutions. For example, to take government out of enterprise operation, the party-state needed specific entities to act as its representative in exercising due ownership rights. Such

agencies were lacking until several line ministries were eventually converted into shareholding agencies through administrative streamlining. Given other ideological breakthroughs and the thriving non-state sector, central government subsequently established stock markets in the 1990s in order to accelerate SOE restructuring. Once reformers realized, the further consequences of equity market underdevelopment they advanced further particular policies to improve investor protection. China's SSG reform has often been implemented through a policy-based, ad hoc approach to address the lack of complementary institutions at an opportune point in time. As noted by Heilmann (2011), such an incremental reform strategy – even if sometimes criticized for perpetuating governance shortcomings and resource misallocation – has nevertheless contributed to the fine-tuning which enabled further SOE reform to proceed.

7.3 Research Findings and Propositions

In light of the above, it is now necessary to review to what extent the research propositions have been specifically responded to.

Proposition 1: Rather than become locked into self-reinforcement among entrenched institutions, China's SSG system will progressively deviate from past central planning, and thereby develop other distinctive characteristics.

China's SSG system has been transformed from an administrative command system to one in which market competition, an increasingly regulatory state, and also a non-state shareholder can and does increasingly dominate. Despite limited efficiency gains, state sector profitability and overall competitiveness have improved. Overall mutual stabilization of the different institutional spheres of the centrally-planning system, or *State Syndicate* model, worked only for a limited time. Nevertheless, the path from its central-planning origins to the current outcome has not been notably radical. It has proceeded more gradually, cumulatively, and without dramatic disruptions and discontinuities. With the legacy of state control focussed upon ownership concentration and board dominance, the perceived governance shortcomings brought serious enough efficiency and legitimacy concerns for the ruling party-state that reforms continued amid such exogenous events as the demise of the former Soviet Union and China's WTO entry.

A principal source of transformation has been changes in the political-economic conditions in which the state sector operates. It has been also shown how changes in capital structure

and further integration with the world economy induced further cognitive reorientation among corporate strategizers which helped bring about improved governance practices. Central policy makers and strategizers in China Life have chosen a continuous and perhaps more familiar incremental path to improve the governance practices. Observed transformations (i.e. corporate restructuring and internal audit system) occurred largely without such major structural changes as radical privatization or thoroughgoing reorganization. In spite of the constraining effects of broader social-political institutions, change agents (i.e. central policymakers, the NAO and internal auditors) could exploit existing organizational arrangements and authority relations to avoid organizational upheavals and resistance. Transitional conditions have significantly redefined what SSG institutions are and do, in particular the respective roles and different visions of the relevant actors.⁴ Changed reform objectives reflect key actors' growing knowledge about both the merits of particular SSG practices and the balance between different interest groups. Thus, the logic of institutional perpetuation is limited in terms of explaining SSG transformation.

Proposition 2: Where the interaction between change agents determines policy outcomes, the significant economic and political interests of central policymakers make them leading change agents for SSG reform.

In terms of interest redistribution, SOE reform has been historically marked by active interaction between, and leading differences among, certain key social actors and change agents. This highlights the central role of social actors actively generating change via two distinct, though interrelated, causal ways. Most directly, emerging actors managed at times to introduce more effective arrangements that dismantled, eroded, reinterpreted or (nearly) displaced seemingly ineffective prior governance practices. Central to their ability to craft and expand such innovative practices are the economic, political and social resources that were “latent in the very institutions they sought to revise” (Jacobs, 2010, p. 124). As regards investor protection, economic liberalization and financial market development enabled public investors to exert more influence over corporate agendas. Their quest for more effective protection was further aided by the government's renewed agenda for corporate restructuring and regulatory reform. These radical changes created a new constituency seeking fairer rules against incumbent corporate insiders while other regulatory reforms likewise fostered anti-incumbent institutions (Rajan and Zingales, 2003).

⁴ For Streeck (2009, p. 251), in contingent conditions, a corporate governance system, in what may be called a deficient mode, may temporarily become subordinate to the progress of marketization and allocative efficiency.

A second mechanism of institutional change, however, sprang from institutional defendants themselves. The economic interests and legitimacy concerns often made central policy makers more responsive and active implementers of SOE reforms than they might otherwise have been. While initial reforms sought to prevent threatened national economic disintegration, changed ownership rights reflected a vision of “forging a state sector with global competitiveness” (Shao, 2012). Repeatedly, central policy makers pushed through major institutional changes intended to address governance shortcomings and improve state sector competitiveness. Changed evaluation criteria suggest that central government is also undergoing a significant cognitive and/or ideological reorientation. Despite rejecting wholesale privatization, the gradual extension of market mechanisms provoked the party-state to change earlier revolutionary rhetoric and adopt *realpolitik* to guide reform. Faced with entrenched corporate insiders, the party-state lost legitimacy because of corruption and other malpractice, in particular the close identity of interests between business executives and officials (as indicated by close-knitted relationships between CIRC and China Life) (Saich, 2011). For SASAC, central government is seeking better oversight over corporate management as part of the effort to reconsolidate state ownership rights. As a result, its role as ultimate planner has been transformed into the owner of strategic state assets. While the central policy makers maintain their espoused commitment to a market-driven economy, one major impact of the current financial crisis has been to increase the presence of government in regulatory reform and industrial restructuring.

At firm level, despite the disciplinary power of capital markets, the transformation of China Life’s governance system can be considered largely state-led. The economic and political importance of this state-owned insurance giant has been repeatedly asserted by the party-state. As noted, central policymakers challenge regulatory and coordinating authorities to orchestrate the disposal of non-performing assets. They craft coalitions with other regulators and thus manage to impose more effective monitoring over entrenched corporate interests. Moreover, meaningful transformation of SSG practices takes place when key actors adapt themselves in line with changed environments. Different reforms, including the reorientation of party evaluation criteria, represent their adaptive response to the changing socio-economic context. For China Life, the meaning of ideological correctness has shifted towards economic efficiency and competitiveness, emphasizing sales growth and profitability. All this indicates the party-state’s continuing efforts to reconcile its legitimacy concerns with the quest for economic efficiency. For Saich (2011), the combination of personnel control and

profitability has created a hybrid economic institution referred to as “*numenklatura* capitalism”. Thus the Chinese party-state should not be conceived as a monolithic apparatus. What is actually “effective” under these circumstances is “a matter of continuing social, political, and economic experimentation, of successive trial and error, and of tentative approximation” which requires not only deductive reasoning and experiential accounting, but also political contestation and a legitimating societal discourse with stakeholders (Streeck, 2009, p. 179).

Proposition 3: China’s SSG reform encounters constraining or/and mediating forces from prevailing social-economic conditions, in particular entrenched interests from prior institutional arrangements.

Despite other enabling conditions, the reform process often encounters institutional constraints and political resistance, in particular from rising corporate power. Different reforms measures often provoke the resistance of those actors they disadvantage. The bargaining and lobbying activities of SOEs still has considerable “residual strength”, not just from the workers affected and the ministries they were transformed from, but because they also contribute so much to national output (about 80 per cent over 2011) and communes 60 per cent of household savings through bank loans (China Statistical Year Book, 2011; see also Saich, 2011). Although such constraints as ideological concerns and interest groups are not insurmountable, they can nevertheless shape ongoing governance reforms. For Grindle and Thomas (1991, p. 126; see also Saich, 2011, p. 264), a “policy reform initiative may be altered or reversed at any life stage in its life cycle by the pressures and reactions of those who oppose it”. It is probable that in contingent conditions, the SSG polity, in what may be called deficient mode, is temporally subordinate to the progress of marketization and allocative efficiency. However, this cannot remain the dominant mode of institutional transformation, especially in a transitional economy in which vested interests remain influential, and complementary socio-economic conditions for better SSG are still underdeveloped.

An appreciation of this helps explain why Chinese SOE reforms have occurred gradually, particularly through myriad “suboptimal” policy arrangements. Despite reformists’ intention to accelerate this, political, administrative and fiscal conditions have limited changes agents’ choices to date. This “lengthy learning process” has absorbed many leading actors (Saich, 2011, p. 254). To neutralize opposition from entrenched interests, reformists forged

coalitions or sought wider compromises. Such compromised solutions have sometimes been identified and subverted by other skilled actors. In the process of corporate restructuring, central policymakers continued the profit retention and administrative welfare systems to elicit entrenched managers' support. Leading members used their board control and administrative privileges to advance their own interests. In other words, state sector reform came at a significant cost of side-payments to the “losers” (as also shown by the reduced profit remittance to SASAC for securing corporate compliance). For Shirk (1993, p. 17), “a reform package that is politically logical is not necessarily economically logical”. The compromise in the writing of new reform policies brought institutional practices that departed from, or even contradicted, better institutional design (Streeck, 2009).

However, inadequate governance arrangements also provide social actors with opportunities to challenge the status quo (Oi and Hua, 2011). As regards corporatization, the absence of a well-developed financial market and political opposition prevented restructuring from being a single step process, moving directly from state ownership to privatization. Instead, central government took “smaller, less invasive and less ideologically alien” steps towards progressive restructuring (Oi and Hua, 2011, p. 20). As a result, China's state sector turned to shareholding or corporatization rather than privatization and thereby settled for partial reform. Since the institutional arrangements first adopted during corporatization were largely second-best choices, mounting governance problems later made central government promote more market-oriented policies through further restructuring. The inherent problems of stage-like sub-optimal policy arrangements reinforced and accelerated the endogenous disorganization which sowed the seeds of further SSG reform.

Proposition 4: To the extent that entrenched institutions exert powerful constraints, strategizers may resort to different path-generation mechanisms to create innovative policy options to ameliorate particular governance shortcomings.

China's SSG institutions can still be populated by resourceful, interpretative actors seeking opportunities for change. Hence, instead of *static* and *rigid* depictions of institutional reproduction, experience here highlights the relations between change agents and institutions as “a dialectical process of mutual shaping over time” (Bell and Feng, 2013, p. 16). SOE reform has become a pluralistic process involving different social actors who employ various transformative strategies based on their own interests (Oi and Hua, 2011). As shown here, change agents affect reform through well-chosen mechanisms (Mintzberg, 1985; Jing and

McDermott, 2012). A good example was how 1990's state sector restructuring was locally extensive but readily contested at the centre (Saich, 2011). For Seo and Greed (2002, p, 229), the formation and transformation of governance practices “are basically political processes involving participants who have divergent interests and unequal power”. These empirical observations demonstrate how institutionally entrepreneurs or change agents craft particular implementation strategies based on their respective political and economic interests. As stakeholders can embrace different transformative mechanisms, they are less resistant to profound changes, producing a continuous feedback between the system evolution and the socio-economic environment in which SSG institutions function (Farrar and Mayes, 2013).

Actors can engage minor but unforeseeably path-breaking, violation of governing institutional norms. Both “layering” and “conversion” represent reform strategies for those Chinese change agents prevented from creating entirely new governance institutions from scratch (Streeck, 2009). Where central government sanctioned enterprise reform, implementation was left to government bureaucracies and key enterprise managers. During initial enterprise reform, reformist leadership employed a layering strategy to craft coalitions with local governments and enterprise managers. In this way, it overcame rival party hard-liners’ resistance. Thus reformists can be considered what Mahoney and Thelen (2010, p. 30) termed the “insurrectionaries” whose interests are at odds with defenders of the status quo, but closely allied with other institutional challengers of rigid administrative planning. In addressing the ideological challenges, party cadres used the existing *nomenklatura* framework as a platform for introducing more subtle changes from the margins, which helped transform corporate governance practices in directions more consistent with their own ideology and preferences.

However, the way actors can also exploit the sub-optimal arrangements or/and conflicts points to how they might advance their own interests at the expense of others. For example, ministries or/and shareholding agencies represent another group of change agents categorized by Mahoney and Thelen (2010, p. 31) as “opportunists” who can only accept changes if leading reformers ensure they also benefit equally from them. Ownership concentration enabled them to manipulate or convert transplanted governance mechanisms using their own considerations and interests. These new institutions broadened the scope for political coalition building. As reforms unfolded, central policy makers encountered

resistance regarding possible redistributive effects rather than ideological fidelity. Social actors altering current governance practices through different transformative strategies can also bring new problems to bear while doing so.

7.4 Methodological Implications of a Path-Based Approach

The incremental and dynamic process of SSG reform also brings important methodological implications to light. To generate fruitful insights into what actually occurs, a path-based approach needs to explore the content, context, and stages of change together through time (see also Stroz et al., 2013). The incremental nature of SOE reform, and other institutional transformation, are difficult to capture in statistical terms alone, and key causal relationships may only be realized retrospectively (Streeck, 2009). For that reason governance researchers may later add other versions of the organizational past and similar institutional legacies to the set of variables and data they first considered. However, the limits of data drawn from narrow bounded time and space have sometimes been overlooked.⁵

The primary task here is to define what an appropriate length of time might be. Duration sets a frame of reference for the changes observed and how these are analysed. The longer an emergent process is observed, and the further back its origins are traced, the more each different change can be pursued in depth. Theoretically and empirically, change and continuity, *path generation* and *path dependence*, pose important time issues. A meaningful inquiry into institutional change needs to accommodate differing origins, causes, temporal patterns and movements from simple continuity through into complex transformation and vice versa. To do this, path-based research like this needs sufficient longitudinal data to enable present practices and arrangements to be explored in relation to their past and projected future (Pettigrew, 1990).

The cumulative dimension of China's SSG reform is evident. But how long does the required time frame need to be? And when does any given change process begin? There are, of course, no absolute and simple answers. As for time, events and process are mapped into a time metric, providing a grid within which different historical events and processes are located (Caporaso, 1980). Events and processes are expressed as transformations within the grid specified (Caporaso, 1980). In a path-based perspective time is no given and

⁵ As noted by Streeck (2009), comparative studies of corporate governance also have a tendency to organize empirical observations in historically invariant.

unquestioned construct. Instead, events and developmental stages themselves construct the metric of analysis; they become the language a path-based approach uses to elucidate transformation and the metric by which to judge temporal results. For Pettigrew (2013), judgments should be made in the light of the theoretical framework adopted, research questions pursued, empirical setting of the inquiry, and the nature and characteristics of the researcher-subject relationship in any site. Or, as argued by Morgan (2006), the key to choosing the appropriate duration of time is to understand the logic of what unfolded in the process of change itself. What is critical here is not the longitudinal order of events but the underlying logic and dynamics that have given such events particular meaning and significance. This is expected to provide the rationale for choice. For a path-based approach, instead of the major exogenous events or critical historical junctures alone, it is also necessary to focus upon key stakeholder interactions and co-evolution between institutions and the socio-economic environment over time. Prevailing research on Chinese SOE reform has often chosen events such as the Third Plenary Session of the Eleventh CCP Central Committee in 1979 or China's entry into WTO in 1998, as the beginning of reform. However, more contextualized, path-based explanations may suggest that these given start points may have been preceded by major disjunctures at higher levels of analysis. These events are undoubtedly important turning points, and indeed particular reform opportunities, as latters became apparent in subsequent years. What they ultimately produced was conditioned by pre-existing socio-economic conditions and actors who were able and willing to take advantage of them (see also Streeck, 2009). Meanwhile, governance researchers may also need to refer to on-going policy reformulation and emerging social sectors. A full time period can thus provide "a more encompassing investigation of successive strategic renewal trajectories" (Kwee et al., 2011, p. 986).

However, judgments on transformation are conditioned both by how long they are observed, and by the experience and interpretation of the social actors or agents involved (Stroz et al., 2013). Their strategies and interplay exert salient influence upon the enactment and/or demise of institutions, "imparting on them a particular bias or dynamic that makes for incremental changes" (Streeck, 2009, p. 245). While elements of path-based research are not appropriate for quantitative surveys, elite interviews here prove helpful for generating meaningful insights. The interview process here tends to be more unstructured or open-ended than in conventional surveys, so that interviewees can stress their own definition of the situation, and other contextual information related to it (Aberbach and Rockman, 2002).

Such in-depth validity is particularly important for path-based research to pursue. However, the unique socio-economic context of China raises particular issues about conducting any longitudinal elite study. First, the present transition means that elites do not necessarily remain stable over time. This is particularly so in a government apparatus which can be more dynamic institution than “the stereotypes might lead one to believe” (Aberbach and Rockman, 2002). Apart from the streamlining and creation of new administrative agencies, officials are often reappointed as the executives of SOEs and vice versa. In this case, prior in-depth investigation of background information is particularly useful, in particular regarding organizational structure and personnel change. Second, contradictory accounts emerge from different informants, given the plurality of government bureaucracies. Interpretation from reform losers can be in striking contrast to beneficiaries’ accounts. Where this occurs, it is useful to expose alternative accounts rather than “accord one privileged status” (Pettigrew, 1990, p. 272). This approach is valuable to appreciate how different versions of transformative reality come to be held by the actors concerned (Kezar, 2003).

Chapter 8

Conclusion

This thesis explores the characteristics and transformative dynamics of the prevailing system of Chinese state sector governance (SSG). Using a path-generation perspective, it examines how the changing social-economic environment and leading social actors' conduct impact upon ultimate SSG practices. By applying a mixed-method strategy at both national and firm levels, it presents a more comprehensive and convincing picture of such governance than anything which could have been derived from just one single method alone. China's overall experience with state sector reform resembles that of a relatively unsynchronised, largely incremental process whose strength is less its coherence than its openness or flexibility to pursue "unexpected and tentative policy solutions that are seized upon when they come up" (Heilmann, 2011, p. 117). Leading social actors and surrounding political-economic conditions demonstrably influenced eventual policy outcomes. The firm-level case study further illuminated how subtle changes among related institutional spheres can expand and ultimately generate meaningfully improved governance practices. Much on-going debate regarding state and/or public sector reform has primarily been concerned with efficiency gains from market liberalisation. However, the findings here suggest that the promulgation and transplantation of reform policies should take the specific socio-economic context of any given country, particularly interaction among key social actors, into greater consideration than before (Streeck, 2009, p. 5). State sector reform goes beyond abstract efficiency and welfare considerations into matters of basic compatibility with prevailing socio-political factors.

Chinese SSG

Marketization and, to a lesser extent, globalisation have deeply transformed the institutions of the central planning and set the ground for the development of a new type of polity and style of SSG (Bellamy and Palumbo, 2010). The reform focus has here shifted from initial ad hoc structural tinkering, towards more comprehensive institution-building across different spheres, including political ideology, law and regulation, fiscal and administrative frameworks, corporate governance (CG), and financial markets (OECD, 2005b). For Saich (2011) the governance practices arising from China's changing political-economic landscape may not mount to a market-oriented system but instead constitute a distinctive, state-centric

governance model that more resembles “state corporatism” in the following aspects.

State dominance. To the extent that authoritarian political institutions are perpetuated in the foreseeable future, the Chinese party-state will dominate SSG arrangements albeit in a less singular, discretionary manner (Dickson, 2001). Despite its diminishing dominance in the national economy, the state sector remains a major source of revenue and employment, and plays an increasing role in industrial restructuring and technological upgrading (Dong and Putterman, 2003; Nolan, 2012). Such a vast constituency base is of paramount political importance for ruling elites (Pei, 2009). Legitimacy and economic concerns give central policymakers leading roles in SSG conduct and reform. The enhanced monitoring of SASAC and other regulatory agencies has demonstrated how central government itself intervened in state-owned enterprises (SOEs) and/or state-controlled corporations (SCCs) in key strategic sectors. At the core of these interventions was the interest intermediation whereby explicitly recognized corporate interests became incorporated into a policy-making and implementation process (see Sarti, 1971) in which legitimacy concerns were of (at least) equal importance with economic factors for the ruling authoritarian regime.

Extensive frameworks. Chinese SSG bears a remarkably complex architecture which Lin and Milhaupt (2013) term a *networked hierarchy*.¹ Its hierarchical aspects are readily apparent: they range from the vertical integration of firms along the production chain, to the top-down character of policy transmission and supervision in an authoritarian political regime (Lin and Milhaupt, 2013). Vertically integrated corporations transmit directives from central policymakers to various shareholding agencies and down through a chain of vertically affiliated firms, which facilitates information flow and policy implementation from the top down and vice versa. However this hierarchical structure is embedded in dense networks not only of other corporate groups, but also of government apparatus and attendant party cells. These foster collaboration and supervision at different levels of policy-enforcement and enterprise management. It also adds incentives for the key actors involved, including prominent officials and top executives, where recognized success leads to promotion and political rewards. For Dickson (2001), this networked hierarchy has emerged as a substitute for coercion, propaganda, and central planning for maintaining party hegemony. As Unger and Chan (1995) argued, it represents a mechanism through which the party-state's grip

¹ For Lin and Milhaupt (2013, p. 707) the principal-agent perspective on listed firms fails to capture the hierarchy and embeddedness of Chinese SSG system.

could be lessened but not released altogether.

Evolving state role. SSG practices are changing significantly amidst accelerated market liberalisation, with intense efforts to raise technical management skills and reinforce state ownership functions (Nolan, 2012). Corporatisation, combined with more decentralised state administration in the 1990s, has enabled selected shareholding entities to dominate major corporate decision-making (OECD, 2005b, 2011b). Aggravated insider control increases the expropriation risk which then hinders further financial market development. Failure to discipline entrenched insiders inhibits enterprise performance and erodes the party-state's legitimacy when pursuing future reforms (Pei, 2009). Recent initiatives intend to reinforce state ownership functions, particularly regarding performance evaluation and capital management. With significant ideological reorientation, the party-state has sought to institutionalise its political oversights through market-based CG mechanisms and professional regulatory organs. The empowerment of a centralised ownership entity, i.e. SASAC, constitutes state ownership rights in a more centralized but still market-oriented manner (Naughton, 2006).

Power structure. The respective interests and authority of central policymakers, state apparatus, local governments, and corporate managers have themselves changed. The once unilateral authority relationship between government and enterprise has since become more bilateral and contestable. SOEs control primarily resides among insider managers sharing various other network linkages (Tam, 2002). Where extant governance institutions have been used to entrench vested interests, other opportunities for management indiscretion and insider expropriation have occurred. However, accelerated marketization also increases public investors' input into policy and business decision-making, as deeper financial markets provides channels for increasing their influence. The prevailing agenda for pension reform and effective state asset management further aid the quest for better protection. The direction of SSG reform may therefore depend upon whether and how central policymakers reconcile that agenda with the interests of other emerging economic actors.

8.1 Elements of SSG Reform

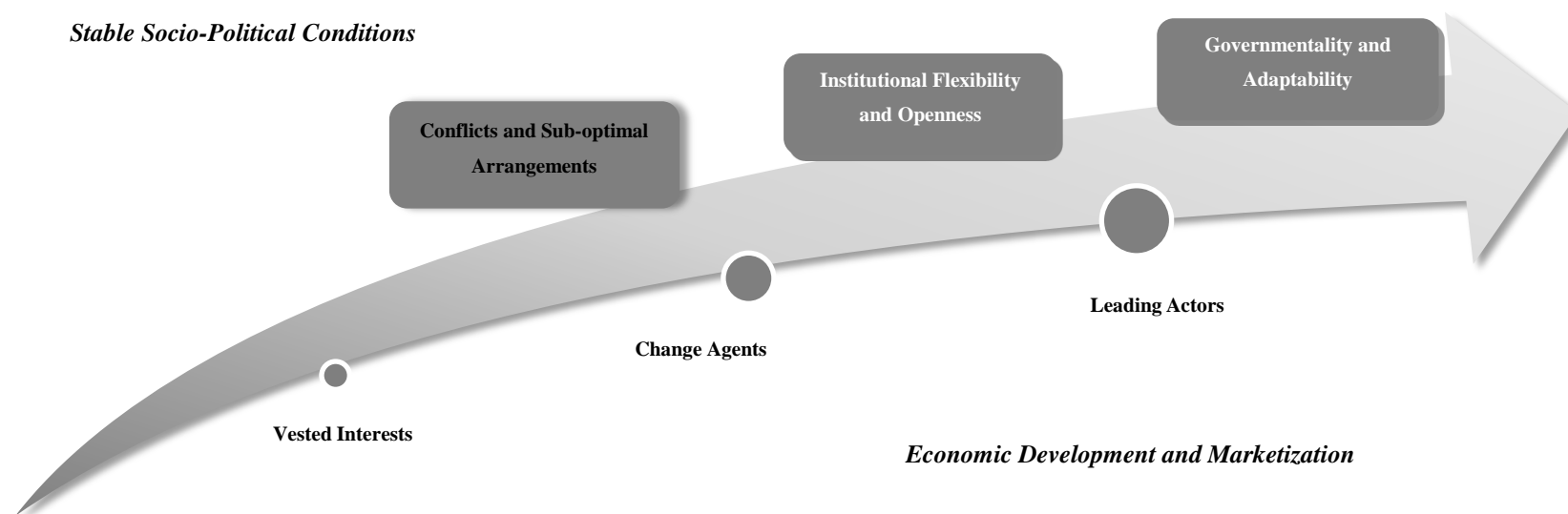
The findings here further call into question those “trapped transition” and “path-dependence” arguments which emphasize institutional “locked-in” and stability above all. For Baum and Shevchenko (1999) the key attraction of the “state corporatism” model is the state's ability to

accommodate party-state control to the more diverse socio-economic changes induced through market liberalisation. As indicated in Figure 8.1, SSG reform here suggests that these elements ensure meaningful transformation:

Stable socio-political environment amid increased marketization. China's economic transition contrasts strikingly with other former socialist economies which adopted a big bang approach. The gradualist approach has brought a stable socio-political environment, which has then seen governance reform even proceed through different leadership successions. A stable socio-political environment is a necessary – though not sufficient – condition for SSG reform. As noted, a principal source of transformation has been the changing economic conditions in which SSG is situated and conducted. The drive to maintain institutionalized party-state dominance provides particular stability and assurance (Saich, 2011, p. 141). Where much prevailing economic-finance literature might demonstrate how major regulatory reforms were preceded by significant market failures, this study here suggests that marketization has imposed competitive pressure upon extant governance practices and brought further improvements. The gradual expansion of market mechanisms, both domestic and international, increases the economic and institutional resources and diversifies the channels available for different stakeholders to exert more influence (Djelic and Quack, 2007).

Institutional flexibility and openness. In China, decentralized authority structures allow novel policy options to overcome strong political resistance; lessons from experimentation were fed back into national policymaking and helped provide the basis for future reform. Many implementation related issues were not necessarily unique to China, and could also arise elsewhere, even if certain particular problems here appeared more acute. In particular, China's size and diversity makes it important that policy and its makers accommodate local variations (Saich, 2011). Policy innovation also requires the prevailing regime to incorporate new economic actors who might voice other, different claims over reform agendas. Such flexibility and openness can, in effect, bring in “institutional seeds” whose “emergent qualities” add other pressures for change.

Figure 8.1 Implications for China's SSG Reform



Skilled social actors and leader authority. The redistributive nature of SSG suggests that reform can hardly occur without also bringing other difficulties for those groups most favoured and protected by the ruling status quo. Whilst responsive and skilful actors can employ innovative strategies to address political-economic constraints, governance reform also requires actors with legitimate authority over others. The retention or enhancement of authority does not mean that reform leaders can impose policies in a recalcitrant manner, or free themselves from due accountability to others. Chinese central policymakers' search for improved managerial oversight suggests an attempt to reconcile their stated policy agenda with the interests of other economic actors. The reorientation of socialist ideology and reform imperatives highlights their adaptability to the changing socio-economic environment, in particular the gradual expansion of market mechanisms. Further considerations include:

Sub-optimal governance arrangements. As noted, the redistributive nature of SSG makes reform both dynamic and contestable. Where policy outcomes are conditioned by the environment and rival interests, those financial economists who emphasize the detrimental effects of governance malpractices often call for radical regulatory enforcement. However, these findings here demonstrate that costly self-destructive dynamism can also lead to deinstitutionalization (see also Streeck, 2009).

8.3 Future Research Agenda and Concluding Remarks

These distinctive policy outcomes suggest several other research avenues for corporate governance scholars to pursue. First, this thesis represents a preliminary attempt to employ path-generation explanation for the Chinese context, but a more explicit theoretical framework is needed to address the issues of: (1) which distinct spheres and/or stages is a particular set of transformative mechanisms likely to emerge, (2) how do/might different transformative mechanisms connect with each other, and (3) how do/might the choice of transformative strategies differ among particular groups of social actors. Better answers to these questions are needed to understand how the Chinese SSG system arrived at its present conjuncture.

Second, the case study selected here focuses on existing key representative actors from several related institutional spheres. With further change, attention might shift towards other emerging economic actors, and their relations with current key stakeholders.

These could include institutional investors and foreign regulatory bodies, whose reform imperatives might provoke more innovative governance practices. The statistical analysis presented here suggests that investors can assess the value of prevailing governance practices via stock price reactions but the question of how this also translates into policy making is still open.

Third, there are the signs of Chinese regulators and companies devising more of their own measures or adapting international standards in local contexts, but still more can be done, “in particular in the area of institutional capacity building” (Makamura, 2008, p. 230). As the reform model remains largely state-led, how might central policymakers reconcile their agenda with other rising social actors in respect of policy and practice? While current practices are underpinned by concentrated ownership, what governance practices prevail in non-state sectors? If state and non-state governance practices converge or diverge, what might the possible policy outcomes be? To the extent the cognitive and normative aspects of governance matter, mixed methods can promise further insights, not least in terms of accounting for real-time actions within and between different institutions (see also Stroz et al., 2013).

There are real issues about why salient institutional differences cannot be fully appreciated without simultaneously looking at wider political-economic foundations and leading social actors (O’Sullivan and Graham, 2010; Kwee, 2013). The key point is that, in order for a state or company to foster sound governance practices, it needs more than just advanced legal institutions; there are other problems which reach into their societal core. As such, it is no surprise that policymakers have often found stylized solutions frustrating or difficult to implement and, even when implemented, compliance is still lacking unless and until complementary economic and political conditions are developed alongside. For example, there may be little demand for independent directors until national political institutions have enabled the necessary institutional foundations for making corporate insiders accountable to operate as intended. This thesis does not intend to justify the legacy of an authoritarian state, but underlines the importance of recognizing due political-economic conditions when analysing observed institutional variations. This recalls Roe’s (2003, p. 204) metaphor about understanding the control of water as it moves in rivers and oceans. One cannot fully understand and make good use of water movement without also investigating the huge gravitational pull of the

moon. For SGG, while viscosity, rainfalls, erosion, and so on are like reform policies, the moon's pull comes from the wider political-economic environment.

Appendices:**STATA Syntax and Results****Appendix 1****Syntax for CAR Calculation and Regression****Data Preparation for Regression**

```
set memory 500m

use "E:\new event study\stock return\eventdates.dta", clear

sort company_id

by company_id: gen eventcount=_N

by company_id: keep if _n==1

sort company_id

keep company_id eventcount

save eventcount

use "E:\new event study\stock return\stockdata.dta", clear

sort company_id

merge company_id using eventcount

tab _merge

keep if _merge==3

drop _merge

expand eventcount

drop eventcount

sort company_id date

by company_id date: gen set=_n
```

```
sort company_id set

save stockdata2

use "E:\new event study\stock return\eventdates.dta", clear

sort company_id

by company_id: gen set=_n

sort company_id set

save eventdates2

use stockdata2, clear

merge company_id set using eventdates2

tab _merge

list company_id if _merge==2

keep if _merge==3

drop _merge

egen group_id = group(company_id set)

sort company_id date

by company_id: gen datenum=_n

by company_id: gen target=datenum if date==event_date

egen td=min(target), by(company_id)

drop target

gen dif=datenum-td

save for_regression
```

Event Window of 11 Day

```
sort company_id
```

```

by company_id: gen event_window=1 if dif>=-5 & dif<=5

egen count_event_obs=count(event_window), by(company_id)

by company_id: gen estimation_window=1 if dif<-30&dif>=-120

egen count_est_obs=count(estimation_window), by(company_id)

replace event_window=0 if event_window==.

replace estimation_window=0 if estimation_window==.

tab company_id if count_event_obs<11

tab company_id if count_est_obs<90

drop if count_event_obs<11

drop if count_est_obs<90

set more off

gen predicted_return=.

egen id=group(company_id)

forvalues i=1(1)482{

  l id company_id if id==`i' & dif==0

  reg ret market_return if id==`i' &estimation_window==1

  predict p if id==`i'

  replace predicted_return = p if id==`i' &event_window==1

  drop p

}

sort id date

gen abnormal_return=ret-predicted_return if event_window==1

by id: egen cumulative_abnormal_return = sum(abnormal_return)

```

sort id date

by id: egen ar_sd = sd(abnormal_return)

gen test =(1/sqrt(11)) * (cumulative_abnormal_return /ar_sd)

list company_id cumulative_abnormal_return test if dif==0

outsheet company_id event_date cumulative_abnormal_return test using stats11_30_120.csv
if dif==0, comma

reg cumulative_abnormal_return if dif==0, robust

egen nmis=rmiss2(ret)

sort company_id

by company_id:egen totalcount=total(nmis) if dif<-30&dif>=-120

outsheet company_id event_date totalcount using missingcheck11.csv if dif== -31, comma

Event Window of 5 Days

sort company_id

by company_id: gen event_window=1 if dif>=-2 & dif<=2

egen count_event_obs=count(event_window), by(company_id)

by company_id: gen estimation_window=1 if dif<-30&dif>=-120

egen count_est_obs=count(estimation_window), by(company_id)

replace event_window=0 if event_window==.

replace estimation_window=0 if estimation_window==.

tab company_id if count_event_obs<5

tab company_id if count_est_obs<90

drop if count_event_obs<5

drop if count_est_obs<90

```

set more off

gen predicted_return=.

egen id=group(company_id)

forvalues i=1(1)487{

l id company_id if id==`i' & dif==0

reg ret market_return if id==`i' & estimation_window==1

predict p if id==`i'

replace predicted_return = p if id==`i' & event_window==1

drop p

}

sort id date

gen abnormal_return=ret-predicted_return if event_window==1

by id: egen cumulative_abnormal_return = sum(abnormal_return)

sort id date

by id: egen ar_sd = sd(abnormal_return)

gen test =(1/sqrt(5)) * ( cumulative_abnormal_return /ar_sd)

list company_id cumulative_abnormal_return test if dif==0

outsheet company_id event_date cumulative_abnormal_return test using stats05_30_120.csv
if dif==0, comma

reg cumulative_abnormal_return if dif==0, robust

egen nmis=rmiss2(ret)

sort company_id

by company_id:egen totalcount=total(nmis) if dif<-30&dif>=-120

```


outsheet company_id event_date totalcount using missingcheck05.csv if dif== -31, comma

Event Window of 3 Days

sort company_id

by company_id: gen event_window=1 if dif>=-1 & dif<=1

egen count_event_obs=count(event_window), by(company_id)

by company_id: gen estimation_window=1 if dif<-30&dif>=-120

egen count_est_obs=count(estimation_window), by(company_id)

replace event_window=0 if event_window==.

replace estimation_window=0 if estimation_window==.

tab company_id if count_event_obs<3

tab company_id if count_est_obs<90

drop if count_event_obs<3

drop if count_est_obs<90

set more off

gen predicted_return=.

egen id=group(company_id)

forvalues i=1(1)487{

l id company_id if id==`i' & dif==0

reg ret market_return if id==`i' & estimation_window==1

predict p if id==`i'

replace predicted_return = p if id==`i' & event_window==1

drop p

}

sort id date

gen abnormal_return=ret-predicted_return if event_window==1

by id: egen cumulative_abnormal_return = sum(abnormal_return)

sort id date

by id: egen ar_sd = sd(abnormal_return)

gen test =(1/sqrt(3)) * (cumulative_abnormal_return /ar_sd)

list company_id cumulative_abnormal_return test if dif==0

outsheet company_id event_date cumulative_abnormal_return test using stats03_30_120.csv
if dif==0, comma

reg cumulative_abnormal_return if dif==0, robust

egen nmis=rmiss2(ret)

sort company_id

by company_id:egen totalcount=total(nmis) if dif<-30&dif>=-120

outsheet company_id event_date totalcount using missingcheck.csv if dif== -31, comma

Event Window of 2 Days

sort company_id

by company_id: gen event_window=1 if dif>=-1 & dif<=0

egen count_event_obs=count(event_window), by(company_id)

by company_id: gen estimation_window=1 if dif<-30&dif>=-120

egen count_est_obs=count(estimation_window), by(company_id)

replace event_window=0 if event_window==.

replace estimation_window=0 if estimation_window==.

tab company_id if count_event_obs<2

```
tab company_id if count_est_obs<90

drop if count_event_obs<2

drop if count_est_obs<90

set more off

gen predicted_return=.

egen id=group(company_id)

forvalues i=1(1)487{

l id company_id if id==`i' & dif==0

reg ret market_return if id==`i' &estimation_window==1

predict p if id==`i'

replace predicted_return = p if id==`i' &event_window==1

drop p

}

sort id date

gen abnormal_return=ret-predicted_return if event_window==1

by id: egen cumulative_abnormal_return = sum(abnormal_return)

sort id date

by id: egen ar_sd = sd(abnormal_return)

gen test =(1/sqrt(2)) * ( cumulative_abnormal_return /ar_sd)

list company_id cumulative_abnormal_return test if dif==0

outsheet company_id event_date cumulative_abnormal_return test using stats02_30_120.csv
if dif==0, comma

reg cumulative_abnormal_return if dif==0, robust
```

```
egen nmis=rmiss2(ret)
```

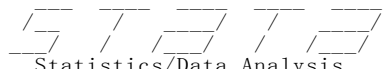
```
sort company_id
```

```
by company_id:egen totalcount=total(nmis) if dif<-30&dif>=-120
```

```
outsheet company_id event_date totalcount using missingcheck02.csv if dif==31, comma
```

Appendix 2

Syntax and Result for Cross-Sectional Regression in Chapter 5

 (R)
 11.0 Copyright 1984–2009
 Statistics/Data Analysis StataCorp
 4905 Lakeway Drive
 College Station, Texas 77845 USA
 800-STATA-PC <http://www.stata.com>
 979-696-4600 stata@stata.com
 979-696-4601 (fax)

Single-user Stata license expires 31 Dec 9999:

Serial number: 71606281563
 Licensed to: STATAForAll
 STATA

Notes:

1. (/m# option or -set memory-) 50.00 MB allocated to data
2. (/v# option or -set maxvar-) 5000 maximum variables
3. New update available; type -update all-

running D:\Stata11\profile.do ...

. use "C:\Users\Administrator\Desktop\µÛÏãÔÃ%0Ãæ»0' éÊý%ÝÐp, Å° Å (ÒÑÉ¼%ô£©.dta", clear

. regress car3_30_120 fa fs tq1 de roa opm ts_dummy i.year, vce(cluster sic_code)

Linear regression

Number of obs = 432
 F(23, 84) = .
 Prob > F = .
 R-squared = 0.1139
 Root MSE = .07192

(Std. Err. adjusted for 85 clusters in sic_code)

car3_30_120	Coef.	Robust Std. Err.	t	P> t	[95% Conf. Interval]	
fa	-.0007725	.0002924	-2.64	0.010	-.0013541	-.000191
fs	-.0051255	.0016983	-3.02	0.003	-.0085028	-.0017482
tq1	-.0025038	.0009459	-2.65	0.010	-.0043849	-.0006227
de	.0000495	.0000478	1.04	0.303	-.0000456	.0001447
roa	-.0018691	.0006017	-3.11	0.003	-.0030656	-.0006726
opm	.0002152	.0001429	1.51	0.136	-.000069	.0004994
ts_dummy	-.0102968	.006457	-1.59	0.115	-.0231372	.0025436
year						
1994	.0924408	.0537215	1.72	0.089	-.0143902	.1992719
1996	.1753761	.056407	3.11	0.003	.0632046	.2875476
1997	.1354579	.0565157	2.40	0.019	.0230702	.2478457
1998	.0594117	.0673472	0.88	0.380	-.0745156	.193339
1999	.2083767	.0985065	2.12	0.037	.0124857	.4042678
2000	.1050979	.0610781	1.72	0.089	-.0163626	.2265584
2001	.1246577	.0582491	2.14	0.035	.0088229	.2404924
2002	.1196824	.0551004	2.17	0.033	.0101091	.2292557
2003	.1140644	.057986	1.97	0.052	-.0012471	.2293758
2004	.1147566	.0564353	2.03	0.045	.0025289	.2269844
2005	.1272494	.0574989	2.21	0.030	.0129065	.2415922
2006	.1463976	.0583274	2.51	0.014	.0304071	.262388
2007	.1450267	.0589411	2.46	0.016	.0278158	.2622376
2008	.1473239	.0567638	2.60	0.011	.0344429	.2602049
2009	.1354662	.0612513	2.21	0.030	.0136614	.257271
2010	.1459736	.0566559	2.58	0.012	.0333072	.25864
2011	.145998	.0566225	2.58	0.012	.0333978	.2585981
2012	.1454303	.0592563	2.45	0.016	.0275926	.263268
_cons	-.0129367	.0528772	-0.24	0.807	-.1180889	.0922155

```
. regress car3_30_120 fa fs tq1 de roa opm ts_dummy gf_dummy i.year, vce(cluster sic_code)
```

Linear regression

Number of obs = 375
 $F(20, 76) =$
 Prob > F =
 R-squared = 0.1077
 Root MSE = .05363

(Std. Err. adjusted for 77 clusters in sic_code)

car3_30_120	Coef.	Robust Std. Err.	t	P> t	[95% Conf. Interval]	
fa	-.0005683	.000236	-2.41	0.018	-.0010383	-.0000983
fs	-.0044226	.0016241	-2.72	0.008	-.0076573	-.0011878
tq1	-.0024277	.0008767	-2.77	0.007	-.0041738	-.0006817
de	3.48e-06	.000032	0.11	0.914	-.0000602	.0000672
roa	-.0018567	.0005208	-3.56	0.001	-.0028941	-.0008194
opm	.000374	.0000871	4.30	0.000	.0002006	.0005474
ts_dummy	-.0043498	.0067324	-0.65	0.520	-.0177586	.009059
gf_dummy	-.0099988	.0081458	-1.23	0.223	-.0262225	.0062249
year						
2000	.0342114	.0314442	1.09	0.280	-.0284151	.096838
2001	.0376056	.0173241	2.17	0.033	.0031016	.0721096
2002	.0528485	.0176646	2.99	0.004	.0176664	.0880305
2003	.0361006	.0298523	1.21	0.230	-.0233555	.0955567
2004	.0331736	.0191576	1.73	0.087	-.0049821	.0713294
2005	.0460368	.0191762	2.40	0.019	.0078441	.0842295
2006	.064846	.0202126	3.21	0.002	.0245891	.1051028
2007	.0624905	.017568	3.56	0.001	.0275009	.0974801
2008	.0669784	.0206816	3.24	0.002	.0257873	.1081695
2009	.0463559	.0140465	3.30	0.001	.01838	.0743319
2010	.0627166	.0210755	2.98	0.004	.020741	.1046921
2011	.0624311	.0153305	4.07	0.000	.0318978	.0929644
2012	.0544708	.0139767	3.90	0.000	.0266338	.0823077
_cons	.0610989	.0331857	1.84	0.070	-.0049961	.127194

```
. regress car3_30_120 fa fs tq1 de roa opm ts_dummy gf_dummy largest_holding i.year, vce(cluster sic_code)
```

Linear regression

Number of obs = 375
 $F(21, 76) =$
 Prob > F =
 R-squared = 0.1163
 Root MSE = .05345

(Std. Err. adjusted for 77 clusters in sic_code)

car3_30_120	Coef.	Robust Std. Err.	t	P> t	[95% Conf. Interval]	
fa	-.0004879	.0002486	-1.96	0.053	-.000983	7.25e-06
fs	-.0048074	.00158	-3.04	0.003	-.0079543	-.0016605
tq1	-.0024123	.0009367	-2.58	0.012	-.004278	-.0005467
de	.0000156	.000031	0.50	0.616	-.0000461	.0000774
roa	-.0018117	.0005183	-3.50	0.001	-.002844	-.0007794
opm	.000364	.0000908	4.01	0.000	.0001832	.0005449
ts_dummy	-.004436	.0067753	-0.65	0.515	-.0179302	.0090582
gf_dummy	-.0183278	.0092667	-1.98	0.052	-.0367839	.0001284
largest_ho`g	.0003454	.0001608	2.15	0.035	.0000252	.0006656
year						
2000	.0378051	.0320801	1.18	0.242	-.0260879	.1016981
2001	.0403241	.0179763	2.24	0.028	.0045212	.076127
2002	.0541969	.0174806	3.10	0.003	.0193813	.0890125
2003	.0384794	.0287084	1.34	0.184	-.0186982	.095657
2004	.0356484	.0194193	1.84	0.070	-.0030285	.0743253
2005	.0486018	.0193732	2.51	0.014	.0100167	.0871869
2006	.0653319	.0202134	3.23	0.002	.0250734	.1055905
2007	.0661048	.0171961	3.84	0.000	.0318559	.1003538
2008	.072321	.0207767	3.48	0.001	.0309406	.1137015
2009	.0494031	.0147615	3.35	0.001	.0200029	.0788032
2010	.0667869	.0214219	3.12	0.003	.0241214	.1094524
2011	.0675017	.0160596	4.20	0.000	.0355162	.0994871
2012	.0588898	.014455	4.07	0.000	.0301002	.0876794
_cons	.0508208	.032549	1.56	0.123	-.0140062	.1156477

```
. regress car3_30_120 fa fs tq1 de roa opm ts_dummy gf_dummy cso_dummy_r i.year, vce(cluster
> sic_code)
```

Linear regression

Number of obs = 375
 $F(21, 76) =$
 Prob > F =
 R-squared = 0.1298
 Root MSE = .05304

(Std. Err. adjusted for 77 clusters in sic_code)

car3_30_120	Coef.	Robust Std. Err.	t	P> t	[95% Conf. Interval]	
fa	-.0005886	.0002371	-2.48	0.015	-.0010608	-.0001163
fs	-.006252	.001716	-3.64	0.000	-.0096697	-.0028343
tq1	-.0023513	.000782	-3.01	0.004	-.0039089	-.0007938
de	3.49e-06	.0000318	0.11	0.913	-.0000598	.0000667
roa	-.0017938	.0004889	-3.67	0.000	-.0027675	-.00082
opm	.0003806	.0000876	4.34	0.000	.0002061	.0005552
ts_dummy	-.0033691	.0064232	-0.52	0.601	-.016162	.0094237
gf_dummy	-.0196189	.00951	-2.06	0.043	-.0385598	-.0006781
cso_dummy_r	.0228111	.0090165	2.53	0.013	.0048531	.040769
year						
2000	.0440498	.0340334	1.29	0.199	-.0237335	.1118332
2001	.0363791	.0176059	2.07	0.042	.0013138	.0714443
2002	.0524833	.016967	3.09	0.003	.0186906	.086276
2003	.0406551	.0278551	1.46	0.149	-.0148232	.0961334
2004	.0373707	.0184217	2.03	0.046	.0006806	.0740607
2005	.0487565	.0183437	2.66	0.010	.0122218	.0852912
2006	.0655619	.0197067	3.33	0.001	.0263127	.1048112
2007	.0665688	.0170049	3.91	0.000	.0327006	.100437
2008	.0748968	.0199959	3.75	0.000	.0350716	.114722
2009	.0506816	.0135381	3.74	0.000	.0237181	.0776451
2010	.0701345	.0199525	3.52	0.001	.0303958	.1098733
2011	.0718847	.0152102	4.73	0.000	.041591	.1021784
2012	.0633414	.0145918	4.34	0.000	.0342794	.0924034
_cons	.0804687	.0339822	2.37	0.020	.0127873	.14815

```
. regress car3_30_120 fa fs tq1 de roa opm ts_dummy gf_dummy largest_holding cso_dummy_r i.y
> ear, vce(cluster sic_code)
```

Linear regression

Number of obs = 375
 $F(22, 76) =$
 Prob > F =
 R-squared = 0.1322
 Root MSE = .05304

(Std. Err. adjusted for 77 clusters in sic_code)

car3_30_120	Coef.	Robust Std. Err.	t	P> t	[95% Conf. Interval]	
fa	-.0005414	.0002436	-2.22	0.029	-.0010265	-.0000563
fs	-.0062698	.0017203	-3.64	0.000	-.0096961	-.0028436
tq1	-.002351	.0008207	-2.86	0.005	-.0039856	-.0007163
de	.0000103	.0000308	0.33	0.740	-.0000511	.0000717
roa	-.0017754	.0004882	-3.64	0.001	-.0027476	-.0008031
opm	.0003743	.0000891	4.20	0.000	.000197	.0005517
ts_dummy	-.0035232	.0064872	-0.54	0.589	-.0164436	.0093973
gf_dummy	-.0232391	.0099494	-2.34	0.022	-.043055	-.0034233
largest_ho~g	.0001932	.0001618	1.19	0.236	-.0001292	.0005155
cso_dummy_r	.0203498	.0096596	2.11	0.038	.001111	.0395886
year						
2000	.0449982	.0340443	1.32	0.190	-.022807	.1128033
2001	.0380318	.0179843	2.11	0.038	.002213	.0738506
2002	.0532769	.0169397	3.15	0.002	.0195385	.0870152
2003	.0414941	.0274847	1.51	0.135	-.0132464	.0962345
2004	.0383019	.0186939	2.05	0.044	.0010697	.0755341
2005	.0498976	.0185284	2.69	0.009	.0129952	.0868
2006	.0657565	.0198167	3.32	0.001	.0262881	.1052248
2007	.0681502	.0168534	4.04	0.000	.0345838	.1017165
2008	.0770304	.0202194	3.81	0.000	.0367599	.1173009
2009	.0519191	.0140099	3.71	0.000	.024016	.0798221
2010	.0716106	.0201948	3.55	0.001	.0313892	.111832
2011	.0737005	.0155327	4.74	0.000	.0427644	.1046366
2012	.0648557	.014657	4.42	0.000	.0356638	.0940477
_cons	.0726304	.0347699	2.09	0.040	.0033802	.1418806

```
. regress car3_30_120 fa fs tq1 de roa opm ts_dummy gf_dummy lgo_dummy i.year, vce(cluster sic_code)
> ic_code)
```

Linear regression

Number of obs = 375
 F(21, 76) = .
 Prob > F = .
 R-squared = 0.1182
 Root MSE = .05339

(Std. Err. adjusted for 77 clusters in sic_code)

car3_30_120	Coef.	Robust Std. Err.	t	P> t	[95% Conf. Interval]	
fa	-.000592	.0002372	-2.50	0.015	-.0010643	-.0001196
fs	-.0052832	.0016722	-3.16	0.002	-.0086136	-.0019528
tq1	-.0025529	.0008438	-3.03	0.003	-.0042335	-.0008722
de	6.52e-06	.0000324	0.20	0.841	-.000058	.000071
roa	-.0017979	.0005252	-3.42	0.001	-.0028438	-.000752
opm	.0004036	.0000898	4.50	0.000	.0002248	.0005825
ts_dummy	-.0027077	.006259	-0.43	0.667	-.0151736	.0097582
gf_dummy	-.018131	.0090287	-2.01	0.048	-.0361132	-.0001489
lgo_dummy	-.0173322	.0095307	-1.82	0.073	-.0363143	.0016498
year						
2000	.0430157	.0330967	1.30	0.198	-.0229021	.1089334
2001	.037757	.0173054	2.18	0.032	.0032903	.0722237
2002	.0535083	.0168887	3.17	0.002	.0198715	.0871451
2003	.0366891	.0301971	1.21	0.228	-.0234536	.0968317
2004	.0358055	.0186979	1.91	0.059	-.0014345	.0730456
2005	.0475017	.0184587	2.57	0.012	.0107381	.0842653
2006	.0650105	.0197891	3.29	0.002	.0255971	.104424
2007	.0647621	.0171144	3.78	0.000	.0306758	.0988484
2008	.0694967	.0195391	3.56	0.001	.0305812	.1084121
2009	.0483193	.0132547	3.65	0.000	.0219202	.0747184
2010	.0648796	.0198182	3.27	0.002	.0254083	.1043509
2011	.0639374	.0148738	4.30	0.000	.0343137	.0935612
2012	.0591511	.0137814	4.29	0.000	.031703	.0865992
_cons	.0839162	.0369493	2.27	0.026	.0103253	.1575072

```
. regress car3_30_120 fa fs tq1 de roa opm ts_dummy gf_dummy largest_holding lgo_dummy i.yea
> r, vce(cluster sic_code)
```

Linear regression

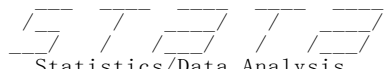
Number of obs = 375
 F(22, 76) = .
 Prob > F = .
 R-squared = 0.1247
 Root MSE = .05327

(Std. Err. adjusted for 77 clusters in sic_code)

car3_30_120	Coef.	Robust Std. Err.	t	P> t	[95% Conf. Interval]	
fa	-.0005193	.0002505	-2.07	0.042	-.0010182	-.0000204
fs	-.0055335	.0016444	-3.37	0.001	-.0088085	-.0022584
tq1	-.0025269	.0008952	-2.82	0.006	-.0043098	-.000744
de	.0000168	.0000315	0.53	0.594	-.0000459	.0000796
roa	-.0017644	.0005218	-3.38	0.001	-.0028036	-.0007252
opm	.0003919	.0000933	4.20	0.000	.000206	.0005778
ts_dummy	-.0029476	.006365	-0.46	0.645	-.0156245	.0097294
gf_dummy	-.0245996	.0097144	-2.53	0.013	-.0439475	-.0052517
largest_ho~g	.000302	.0001682	1.80	0.077	-.000033	.0006371
lgo_dummy	-.0155959	.0098854	-1.58	0.119	-.0352844	.0040926
year						
2000	.0452761	.0333644	1.36	0.179	-.0211749	.1117272
2001	.040119	.0179746	2.23	0.029	.0043195	.0759185
2002	.0546214	.0169442	3.22	0.002	.020874	.0883687
2003	.0387103	.0290758	1.33	0.187	-.0191991	.0966197
2004	.0377059	.0190427	1.98	0.051	-.0002208	.0756327
2005	.0495979	.0187599	2.64	0.010	.0122342	.0869616
2006	.065419	.0199145	3.28	0.002	.0257558	.1050822
2007	.0676951	.0169295	4.00	0.000	.0339771	.101413
2008	.0739162	.0198867	3.72	0.000	.0343084	.1135241
2009	.0507872	.0140408	3.62	0.001	.0228225	.0787518
2010	.0682222	.0202687	3.37	0.001	.0278535	.1085909
2011	.0682204	.0157298	4.34	0.000	.0368919	.099549
2012	.0625464	.0142072	4.40	0.000	.0342502	.0908425
_cons	.0726427	.0377141	1.93	0.058	-.0024714	.1477568

Appendix 3

Syntax and Result for Cross-Sectional Regression in Chapter 6

 (R)
 11.0 Copyright 1984–2009
 Statistics/Data Analysis StataCorp
 4905 Lakeway Drive
 College Station, Texas 77845 USA
 800–STATA–PC <http://www.stata.com>
 979–696–4600 stata@stata.com
 979–696–4601 (fax)

Single-user Stata license expires 31 Dec 9999:

Serial number: 71606281563
 Licensed to: STATAForAll
 STATA

Notes:

1. (/m# option or -set memory-) 50.00 MB allocated to data
2. (/v# option or -set maxvar-) 5000 maximum variables
3. New update available; type -update all-

running D:\Stata11\profile.do ...

. use "C:\Users\Administrator\Desktop\µŭîâŏÂ%ŏŦæ»0' éÊý%ŶĐĐ, Ā° Ā (ŎÑÉ%ŏŦ£©.dta", clear

. regress car3_30_120 fa fs tq1 de roa opm ts_dummy gf_dummy BOD_indp i.year, vce(cluster sic
> _code)

Linear regression

Number of obs = 372
 F(21, 75) = .
 Prob > F = .
 R-squared = 0.1158
 Root MSE = .05313

(Std. Err. adjusted for 76 clusters in sic_code)

car3_30_120	Coef.	Robust Std. Err.	t	P> t	[95% Conf. Interval]	
fa	-.0005947	.0002389	-2.49	0.015	-.0010706	-.0001187
fs	-.0045496	.0016583	-2.74	0.008	-.0078532	-.001246
tq1	-.0025497	.0008598	-2.97	0.004	-.0042626	-.0008369
de	-2.16e-06	.0000304	-0.07	0.943	-.0000627	.0000583
roa	-.0019187	.0005216	-3.68	0.000	-.0029579	-.0008796
opm	.0003838	.0000848	4.53	0.000	.0002149	.0005527
ts_dummy	-.0054274	.0069396	-0.78	0.437	-.0192518	.008397
gf_dummy	-.0102739	.0080616	-1.27	0.206	-.0263335	.0057856
BOD_indp	-.0001401	.0005218	-0.27	0.789	-.0011796	.0008994
year						
2000	.0321917	.0313413	1.03	0.308	-.0302435	.0946268
2001	.0356949	.0171953	2.08	0.041	.0014402	.0699497
2002	.0531341	.0177473	2.99	0.004	.0177797	.0884885
2003	.0369072	.0280436	1.32	0.192	-.0189586	.092773
2004	.032726	.0188071	1.74	0.086	-.0047396	.0701917
2005	.046005	.0190453	2.42	0.018	.0080649	.0839451
2006	.0649578	.0199997	3.25	0.002	.0251163	.1047994
2007	.0624332	.0184873	3.38	0.001	.0256046	.0992619
2008	.0716802	.0215361	3.33	0.001	.0287781	.1145822
2009	.0473964	.0151364	3.13	0.002	.0172431	.0775497
2010	.0637277	.021786	2.93	0.005	.0203277	.1071277
2011	.0641766	.0163279	3.93	0.000	.0316497	.0967034
2012	.0556113	.0151307	3.68	0.000	.0254695	.0857531
_cons	.0694452	.0407215	1.71	0.092	-.0116761	.1505665

```
. regress car3_30_120 fa fs tq1 de roa opm ts_dummy gf_dummy supb_size i.year, vce(cluster s
> ic_code)
```

Linear regression

Number of obs = 372
 $F(21, 75) = .$
 Prob > F = .
 R-squared = 0.1230
 Root MSE = .05291

(Std. Err. adjusted for 76 clusters in sic_code)

car3_30_120	Coef.	Robust Std. Err.	t	P> t	[95% Conf. Interval]	
fa	-.0007133	.0002691	-2.65	0.010	-.0012494	-.0001773
fs	-.0029222	.0018882	-1.55	0.126	-.0066836	.0008393
tq1	-.0023537	.0008119	-2.90	0.005	-.003971	-.0007364
de	-1.52e-06	.0000316	-0.05	0.962	-.0000645	.0000614
roa	-.0019132	.0005057	-3.78	0.000	-.0029206	-.0009057
opm	.000352	.0000831	4.24	0.000	.0001864	.0005176
ts_dummy	-.004671	.0067006	-0.70	0.488	-.0180193	.0086772
gf_dummy	-.0121995	.007725	-1.58	0.118	-.0275886	.0031895
supb_size	-.0017252	.0010788	-1.60	0.114	-.0038743	.0004239
year						
2000	.0286874	.0327359	0.88	0.384	-.0365258	.0939007
2001	.0320592	.0179148	1.79	0.078	-.0036289	.0677473
2002	.0484458	.0180762	2.68	0.009	.0124363	.0844554
2003	.0302369	.0299127	1.01	0.315	-.0293521	.089826
2004	.0311384	.0191125	1.63	0.107	-.0069357	.0692125
2005	.0409145	.0199681	2.05	0.044	.001136	.0806931
2006	.0603956	.020817	2.90	0.005	.018926	.1018652
2007	.0588078	.0177797	3.31	0.001	.0233889	.0942267
2008	.0683718	.0210066	3.25	0.002	.0265244	.1102191
2009	.042798	.0145567	2.94	0.004	.0137995	.0717965
2010	.0608276	.0216252	2.81	0.006	.017748	.1039072
2011	.0592407	.0165644	3.58	0.001	.0262427	.0922386
2012	.0531479	.0156209	3.40	0.001	.0220295	.0842663
_cons	.0486496	.0330157	1.47	0.145	-.0171209	.1144202

```
. regress car3_30_120 fa fs tq1 de roa opm ts_dummy gf_dummy AUD_indp i.year, vce(cluster s
> ic_code)
```

Linear regression

Number of obs = 372
 $F(21, 75) = .$
 Prob > F = .
 R-squared = 0.1224
 Root MSE = .05293

(Std. Err. adjusted for 76 clusters in sic_code)

car3_30_120	Coef.	Robust Std. Err.	t	P> t	[95% Conf. Interval]	
fa	-.0004727	.0002366	-2.00	0.049	-.000944	-1.37e-06
fs	-.004061	.0016197	-2.51	0.014	-.0072875	-.0008344
tq1	-.0025313	.0008479	-2.99	0.004	-.0042204	-.0008422
de	3.38e-06	.0000319	0.11	0.916	-.0000603	.000067
roa	-.0019434	.0005135	-3.78	0.000	-.0029663	-.0009204
opm	.0003974	.000085	4.68	0.000	.0002282	.0005667
ts_dummy	-.0040558	.0066193	-0.61	0.542	-.0172421	.0091305
gf_dummy	-.0160399	.0081797	-1.96	0.054	-.0323347	.0002548
AUD_indp	.0002478	.0001376	1.80	0.076	-.0000264	.0005219
year						
2000	.020124	.0346535	0.58	0.563	-.0489092	.0891573
2001	.0283566	.018203	1.56	0.123	-.0079056	.0646187
2002	.0380709	.0209259	1.82	0.073	-.0036156	.0797574
2003	.0231383	.0330782	0.70	0.486	-.0427568	.0890334
2004	.0206831	.0220923	0.94	0.352	-.0233271	.0646932
2005	.0291755	.023471	1.24	0.218	-.0175812	.0759321
2006	.0496472	.0242047	2.05	0.044	.0014289	.0978654
2007	.0465498	.0200145	2.33	0.023	.0066788	.0864208
2008	.0551388	.0244603	2.25	0.027	.0064113	.1038662
2009	.030789	.0191317	1.61	0.112	-.0073232	.0689012
2010	.0467541	.0239189	1.95	0.054	-.0008948	.0944029
2011	.0477393	.0199485	2.39	0.019	.0079999	.0874786
2012	.0403231	.0179889	2.24	0.028	.0044875	.0761588
_cons	.0530888	.0319719	1.66	0.101	-.0106025	.1167801

```
. regress car3_30_120 fa fs tq1 de roa opm ts_dummy gf_dummy CEO_duality BOD_indp i.year, vc
> e(cluster sic_code)
```

Linear regression

Number of obs = 372
 F(22, 75) = .
 Prob > F = .
 R-squared = 0.1159
 Root MSE = .0532

(Std. Err. adjusted for 76 clusters in sic_code)

car3_30_120	Coef.	Robust Std. Err.	t	P> t	[95% Conf. Interval]	
fa	-.0005986	.0002375	-2.52	0.014	-.0010716	-.0001256
fs	-.0045403	.0016492	-2.75	0.007	-.0078257	-.0012549
tq1	-.0025258	.0008581	-2.94	0.004	-.0042353	-.0008163
de	-2.20e-06	.0000304	-0.07	0.942	-.0000627	.0000583
roa	-.0018957	.0005286	-3.59	0.001	-.0029487	-.0008426
opm	.0003823	.0000858	4.46	0.000	.0002114	.0005532
ts_dummy	-.0054284	.0069423	-0.78	0.437	-.0192582	.0084013
gf_dummy	-.010271	.0080561	-1.27	0.206	-.0263195	.0057775
CEO_duality	-.0014868	.0075034	-0.20	0.843	-.0164343	.0134607
BOD_indp	-.0001273	.0005073	-0.25	0.803	-.001138	.0008834
year						
2000	.0317872	.0313303	1.01	0.314	-.0306261	.0942004
2001	.0353974	.0171038	2.07	0.042	.0013249	.06947
2002	.0528821	.0175484	3.01	0.004	.0179239	.0878402
2003	.036782	.0280502	1.31	0.194	-.0190968	.0926609
2004	.0324824	.0185446	1.75	0.084	-.0044603	.0694251
2005	.0459864	.0190543	2.41	0.018	.0080283	.0839446
2006	.0646106	.0197578	3.27	0.002	.025251	.1039701
2007	.0623368	.0183615	3.39	0.001	.0257588	.0989149
2008	.071409	.0213725	3.34	0.001	.0288327	.1139852
2009	.0470042	.0146028	3.22	0.002	.017914	.0760943
2010	.0634025	.0213293	2.97	0.004	.0209124	.1058926
2011	.0638409	.0159046	4.01	0.000	.0321573	.0955244
2012	.0555023	.0150291	3.69	0.000	.0255628	.0854417
_cons	.0693286	.0406734	1.70	0.092	-.0116971	.1503542

```
. regress car3_30_120 fa fs tq1 de roa opm ts_dummy gf_dummy CEO_duality supb_size i.year, vc
> e(cluster sic_code)
```

Linear regression

Number of obs = 372
 F(22, 75) = .
 Prob > F = .
 R-squared = 0.1241
 Root MSE = .05295

(Std. Err. adjusted for 76 clusters in sic_code)

car3_30_120	Coef.	Robust Std. Err.	t	P> t	[95% Conf. Interval]	
fa	-.0007434	.0002729	-2.72	0.008	-.0012871	-.0001998
fs	-.0027617	.0018983	-1.45	0.150	-.0065434	.00102
tq1	-.0022563	.0008246	-2.74	0.008	-.0038989	-.0006137
de	-1.91e-06	.0000313	-0.06	0.951	-.0000642	.0000604
roa	-.0018351	.0005201	-3.53	0.001	-.0028711	-.0007991
opm	.0003459	.0000854	4.05	0.000	.0001756	.0005161
ts_dummy	-.0047474	.0066708	-0.71	0.479	-.0180362	.0085414
gf_dummy	-.0124702	.0074914	-1.66	0.100	-.0273939	.0024534
CEO_duality	-.0050782	.0080572	-0.63	0.530	-.0211291	.0109726
supb_size	-.0018864	.0011269	-1.67	0.098	-.0041313	.0003586
year						
2000	.026731	.0328776	0.81	0.419	-.0387644	.0922265
2001	.0304563	.0179862	1.69	0.095	-.005374	.0662867
2002	.0476007	.0180656	2.63	0.010	.0116121	.0835893
2003	.0297611	.0297235	1.00	0.320	-.0294512	.0889734
2004	.0303111	.0190807	1.59	0.116	-.0076996	.0683219
2005	.0406803	.0199558	2.04	0.045	.0009262	.0804344
2006	.0590968	.020821	2.84	0.006	.0176192	.1005744
2007	.0585265	.0177898	3.29	0.002	.0230873	.0939657
2008	.0677396	.0210843	3.21	0.002	.0257375	.1097418
2009	.0415983	.0144291	2.88	0.005	.012854	.0703425
2010	.0599882	.0214576	2.80	0.007	.0172425	.1027339
2011	.0582004	.0165657	3.51	0.001	.0251999	.091201
2012	.0530371	.0158089	3.35	0.001	.0215442	.0845299
_cons	.0484295	.0331397	1.46	0.148	-.0175881	.1144472

```
. regress car3_30_120 fa fs tq1 de roa opm ts_dummy gf_dummy CEO_duality AUD_indp i.year, vc
> e(cluster sic_code)
```

Linear regression

Number of obs = 372
 F(22, 75) = .
 Prob > F = .
 R-squared = 0.1229
 Root MSE = .05299

(Std. Err. adjusted for 76 clusters in sic_code)

car3_30_120	Coef.	Robust Std. Err.	t	P> t	[95% Conf. Interval]	
fa	-.0004808	.0002339	-2.06	0.043	-.0009469	-.0000148
fs	-.0040414	.0016155	-2.50	0.015	-.0072596	-.0008232
tq1	-.0024819	.0008536	-2.91	0.005	-.0041824	-.0007814
de	3.27e-06	.0000318	0.10	0.918	-.000006	.0000665
roa	-.0018962	.000525	-3.61	0.001	-.0029421	-.0008503
opm	.0003957	.0000864	4.58	0.000	.0002236	.0005678
ts_dummy	-.0040999	.0065881	-0.62	0.536	-.0172239	.0090242
gf_dummy	-.0162354	.0080501	-2.02	0.047	-.032272	-.0001989
CEO_duality	-.0031246	.0079429	-0.39	0.695	-.0189476	.0126984
AUD_indp	.0002541	.0001408	1.81	0.075	-.0000263	.0005345
year						
2000	.0188324	.0347439	0.54	0.589	-.050381	.0880458
2001	.027411	.0181492	1.51	0.135	-.0087441	.063566
2002	.0373992	.020993	1.78	0.079	-.004421	.0792193
2003	.0228313	.0331279	0.69	0.493	-.0431629	.0888255
2004	.0199451	.0220293	0.91	0.368	-.0239395	.0638297
2005	.0288693	.0233937	1.23	0.221	-.0177335	.075472
2006	.0486938	.0242895	2.00	0.049	.0003066	.0970809
2007	.0461482	.0199182	2.32	0.023	.0064691	.0858273
2008	.0544692	.0245005	2.22	0.029	.0056616	.1032768
2009	.0298453	.0191551	1.56	0.123	-.0083136	.0680041
2010	.0459273	.0237599	1.93	0.057	-.001405	.0932595
2011	.0469176	.0199961	2.35	0.022	.0070834	.0867518
2012	.0399666	.0180692	2.21	0.030	.0039708	.0759624
_cons	.053563	.0320251	1.67	0.099	-.0102343	.1173603

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